The Canadian Chartered Accountant

THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

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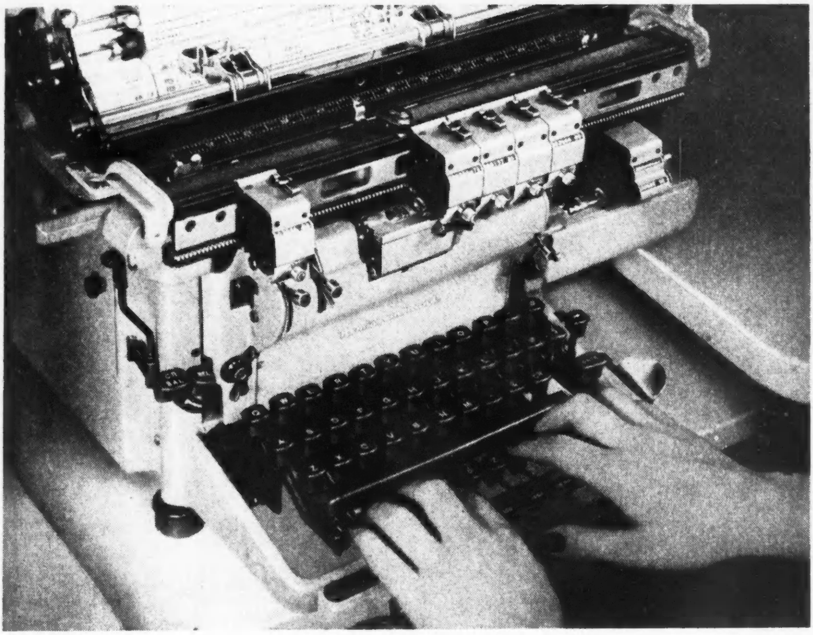

SWEETNESS and LIGHT

By Jay Vee

Arithmetic Gets With It

THE other day we were looking through the school books of a nine-year-old friend and remarked to ourselves what strange things have happened to grade school arithmetic in these postwar years.

The very title of his text, *"Living Arithmetic"*, gives a hint of the kind of change which has taken place. We well recall that no such elegant title graced our early endeavours in the science of numbers. As a matter of fact the initial stage was known simply as "sums". Then when multiplication and division entered the picture, we described our activities as "doing questions". It was only as a near-adult in the top grades that we graduated to the polysyllabic word "arithmetic".

In our day the foundation on which the whole arithmetical superstructure rested was known as "facts". The facts that *one plus two equals three, two plus two equals four,* and so on, were drilled into our minds every morning at five past nine, right after the Lord's Prayer and God Save the King, and all three were treated with an equal amount of reverence. One day our sister's teacher, Miss Bowie, came home to lunch and the discussion turned to some youngsters who were not doing too well at school and were getting into mischief at home. "The whole trouble with them," declared Miss Bowie grimly, "is that they just don't know their facts."

Today "facts" have been replaced by "number stories". Now if Johnnie is to learn that *seven minus two equals five,* he goes in imagination to the Fall Fair, buys seven apples, meets Jimmie and gives him two, and then looks in his bag to see how many are left. Apparently "facts" are too dull for our comic-reading spacemen.

Do any readers remember struggling as we did with the 9-times or 12-times table and wish there was an easy way out? The newest gimmick on the market this year is a pencil box with a simple slide-rule top which when moved across to the figure to be multiplied will give the answer right beside the multiplier. This gadget may be looked on dimly by teachers, but now that *Superman* is back it doesn't take an efficiency expert to see that Junior has to save time somewhere along the line.

Probably the greatest change in the new arithmetic lies, however, in the kinds of problems it poses for the higher grades. When we think back on our entrance class, there can be no doubt that the Department of Education intended us all to be paper-hangers, contractors, or farmers. The number of rooms we decorated (after making allowances for two doors and three windows) and the number of sidewalks we laid (always on all four sides of a lot to trick us into forgetting the corners) saturated us with a knowledge whose tediousness was exceeded only by its uselessness. Yet, for better or for worse it was ingrained into our personalities, and even today when one of our age group comes to call and seems to stare moodily out the window, don't assume that he is bored by the conversation. More than likely he has subconsciously recognized your property as the "lot which requires a picket fence with pickets 4 inches apart", and is busy working the necessary computations.

This breed of man will soon die out if the problems in the new arithmetic

Sweetness and Light

have any influence. Today's twelve-year olds are highly social and artistic enterprisers in embryo. Charles paints a picture at the Community Centre and decides to have it framed. (But when he figures out the frame's perimeter we bet he will be fooled by those corners just the same as we were!) Susan does a roaring business as a baby-sitter and tallies up her week's earnings. But Betty is the pay-off — Betty listens to a lecture on budgeting at the Community Centre and comes home to show her parents how they should manage their money.

However, the lad to be watched most closely by readers of this column is Edward. Edward is a whiz at the one type of problem which Charles, Susan, and Betty will never master and can never avoid — the calculation of income tax! Five gets you eight that some day Edward will be a C.A.!

Vox Pop

THIS issue of *The Canadian Chartered Accountant* has achieved a record of some sort. There are no less than *five* letters to the editor and as far as we know, this is the first time that so many have appeared in one month. It is gratifying to note that three of them seem to have been evoked by various "Sweetness and Light" columns. The managing editor's amused remark is that this sudden flurry of correspondence is not merely eloquent of our column's reception but also of the interest of our readers in accounting theory.

Diplomacy

TODAY even criticism cannot be rendered in blunt Anglo-Saxon language. For instance, take the following complaint about a Toronto roundhouse reported in *The Globe and Mail*: "Every day for hours on end volumes of dense smoke may be observed discharging therefrom."

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COMMENT AND OPINION

Caveat Shareholder!

IF RECENT judgments of the Income Tax Appeal Board should be upheld by the higher Courts some far-reaching consequences in the way of company organization and method of carrying on business may be expected. Last month in these notes we called attention to two decisions of the Board in which it had been held that a sale of property by a minority shareholder to his company was a transaction between the company and, in the language of ITA s. 127(5)(a), "one of several persons by whom it is directly or indirectly controlled". As a consequence, the company was held entitled to capital cost allowances based not on the cost to it of the property purchased but only on the capital cost (which was lower) to the shareholder-vendor.

In both these cases the vendor of the property was not only a shareholder, he was also a member of the board of directors, and it seemed possible to suppose that the decisions were limited to that situation and did not necessarily support the view that any shareholder of a company, without regard to the size of his holdings or his relations with other shareholders, is for tax purposes "one of several persons by whom the company is controlled". We expressed our own fear, however, that such *might* be the effect of these judgments and the hope that our fear would prove unwarranted.

Well, we did not have long to wait to learn that it was our hope and not our fear which appears to be unwarranted. Just the other day Mr. Fisher handed down a judgment in which he goes the whole way. It was the case of a sale of depreciable property to a company by one of its minority shareholders, the company having six shareholders in all, who happened to be brothers. It was argued for the company that the Act did not apply to the sale of property by a mere minority shareholder, and that the words "one of several persons by whom the company is controlled" applied only to a member of a group of shareholders such as a syndicate. Mr. Fisher rejected this contention, though the result would be, he said, "to include any transaction between a corporation and any shareholder, even though he might own only one voting share of the corporation".

If this is so, then Sam Weller's comment that the law is a 'hass would seem to have some merit. If a minority shareholder is, *qua* shareholder, "one of several persons by whom the company is controlled" simply because he possesses voting rights in the company, it seems to us equally logical to say that every member of the legislature fills the same description since the company exists and operates under legislative authority and at all times subject to its power. And, since the legislature is in our system answerable to the voters, it follows by

the same logic that every citizen of Canada is "one of several persons by whom every Canadian corporation is indirectly controlled" within the meaning of the Income Tax Act.

Retirement Pension Plans for the Self-Employed

MR. Abbott's invitation to the accounting profession to examine the whole question of tax incentives towards the creation of retirement pensions for the self-employed has been accepted. Each of our ten provincial Institutes has now before it for consideration a brief prepared by the C.I.C.A. office dealing with all aspects of the problem, and it is hoped that their individual reports to the C.I.C.A. Taxation Committee will enable it to state the consensus of the accounting profession to the Finance Minister before his next Budget is presented to Parliament.

Mr. Abbott's invitation was, of course, not confined to the accounting profession. He mentioned specifically the legal profession also, and there are, in addition, many other professional bodies whose interest in the matter is certainly no less than our own, and many of these, we happen to know, are at the present time also deeply engaged in seeking the answers to the problems posed by the Finance Minister.

It will be recalled that in his remarks to Parliament Mr. Abbott sought to justify the present policy, which allows tax incentives only in the case of employees' pension plans, on the ground of necessity; that the incentive was granted to remove a technical difficulty towards the effective operation of such plans. That argument seems to us to be in reality nothing more than this: the want of a tax incentive (by way of a tax deduction) impedes both employers and employees in their natural desire to create a pension plan: *ergo* create the incentive (i.e. allow the deduction) and pension plans will flourish. Which is precisely what happened. Implicit in this whole argument is the tacit assumption that the creation of pension plans for employed persons merits the support of the whole tax-paying public. Why this same argument does not apply in equal measure to persons who earn their living otherwise than as employees we have never been able to understand, and indeed Mr. Abbott himself made no serious attempt to answer the trenchant criticisms which he encountered in the House of Commons when he gave the above justification for the discrimination in favour of employees' pension plans.

His real objection, it then appeared, was on much wider grounds, that if the tax incentive was allowed to go beyond its present confines it would be difficult to put a limit on it (which seems to us a clear *non sequitur* since he obviously conceives it quite practical to maintain the present limit), and that the effect would likely be to divert an extremely substantial volume of savings into fixed interest investments instead of leaving them or putting them into equities. "I am not sure," he said, "that at this stage of Canada's development I would like to direct people's savings away from equities into debt securities, particularly with the enormous demand for risk capital for the development of our resources. I have not taken a final position," he concluded, "but the difficulties, the inequities, still appal me."

It is here, of course, that the real objection lies, and where the Minister obviously cannot be expected to act until he can confidently recommend a policy to Parliament. Nevertheless we cannot help but feel that some part of the difficulty results from human inertia. When the tax incentive for approved pension plans was first authorized we imagine that no one foresaw the enormous

growth to which they would attain in a very few years. We do not think that the extension of incentives as is now proposed, with an appropriate limitation upon the amount of contributions and adequate safeguards against premature withdrawal, will produce an offspring of the same dimensions as that over whose development Mr. Abbott has presided for some years, and which has been anything but a "problem child".

C.I.C.A. Activities To Be Expanded Again

THE Council of the C.I.C.A. has decided that the work of the Committee on Accounting and Auditing Research is of such importance to the profession that the full time services of a director of research should be provided for. During this last year, as for some years past, the other duties laid upon Mr. Clem King were such that he could not devote more than a small proportion of his time to carrying out his duties as director of research. Council believed that all such duties were necessary and in the interests of the profession. Thus, to enable the Committee on Accounting and Auditing Research to carry out an adequate program, Council has authorized the appointment of another full-time chartered accountant to the Institute staff as soon as possible. This new appointee will be the director of research and henceforth Mr. King will be the executive secretary of the Institute.

One of the more readily apparent duties of the director of research is to assist the committee in the preparation of its research bulletins, so far nine in number. While this requires a great deal of study of accounting and auditing practices in this country and others and of authoritative publications, it is, perhaps, not the most important aspect of the work of a director of research. The basic purpose of the committee is to promote the maintenance of standards for the profession which are at all times adequate to the public need. A full-time director will have a greater proportion of his time available to discuss with members, as individuals and as groups, and in all parts of the country, current accounting and auditing problems, common or uncommon practices, and generally to study and to encourage study of high standards which conform to changing needs.

It is expected also that a full-time director will be able to produce or stimulate the production of more articles and brochures which will be of every day interest and assistance to the members in all fields of professional endeavour.

We believe the committee will find that it will take them some time to find the person for this post but we feel certain that the members of the C.I.C.A. are in full sympathy with the idea and will do all in their power to help the committee.

C.I.C.A. YEAR BOOKS AVAILABLE SHORTLY

The annual White Book of the C.I.C.A., containing reports of the executive, Council, committees, and provincial Institutes, will be off the press in a few days and will be sent to every member.

The Blue Book, which lists the officers, Council, and members of the ten provincial Institutes, will also be published early in November and will be available at the nominal charge of $1.00 per copy.

A form for ordering copies of the Blue Book will be sent to every member with his White Book.

Notes on the Development Of the Accountancy Profession (Part I)

By J. E. Smyth, C.A.
Associate Professor, Queen's University

A discussion of the forces and factors underlying the growth of accounting and the accounting profession

The Genesis of the Profession

IN THE long history of record-keeping the gradual change from Roman numerals (starting about the eleventh century) and the development of the double entry system (in the latter part of the fifteenth century) were the important developments. But the history of record-keeping is quite different from the history of the accountancy profession. It seems that there is no particular distinction in being one of the oldest professions in the world. The accountancy profession is largely a development of the last 60 or 70 years.

The beginnings of the accountancy profession in England, Canada, and the United States are usually traced to the period 1880-1890 because it was in that period that professional accounting societies were first organized. (A professional society was organized in Scotland as early as 1854.) If we insist that the self-governing professional association is a prerequisite to professional standing this analysis will do. On the other hand the mere fact that a group of people constitute themselves a society does not make them professional for that. There are other criteria for professional status.[1] It is more realistic to suppose that certain accountants had been acquiring some of the professional attributes in common before the professional accounting societies were formed.

Responsibility to the client is the important early attribute in the course of achieving professional status. In the field of business the professional man must be trusted if he is to have access to the business records of several concerns; there must be no thought that he might disclose confidential information. From the beginning the dignity and integrity of the professional accountant have been assets as valuable as his competence. (Dignity is merely the form, and integrity the substance, of the professional attitude.) The accountancy profession was able to adapt to its purposes a certain detachment developed somewhat earlier by white collar workers in general and bookkeepers in particular. Charles Lamb, who had been employed as an accountant by the East India Company wrote in 1823 (after having left that

[1] See Lewis and Maude, "Professional People" (Phoenix House, London, 1952), also, "The Criteria for Professional Status", *The Canadian Chartered Accountant*, June 1951.

employment), "The shade of some dead accountant with visionary pen in ear, would flit by me, stiff as in life."[2] Human nature being what it is, it seems unfortunately true that those who are unimpeachable must often also be unapproachable.

Motives for Forming a Professional Association

Some have said that the only motive behind the professional organization is to restrict admission and bid up the price of the services offered. The writer's opinion is of course limited by his opportunity for personal observation, but he is not impressed that professional men are as much preoccupied with this notion as many people think.

There are at any rate other factors to consider. First, a professional body is necessary if members are to be disciplined for breaches of faith; and much of the attractiveness of professional services to clients depends upon the faith which the client places (correctly or incorrectly) in the practitioner.

But human nature being what it is, mistakes are bound to occur. (For the sake of self-respect, we shall think of those mistakes which transcend vigilance and great skill.) The professional association serves the useful role of casting a mantle of irreproachability about members who practise daily in an area in which at least some errors of judgment are inevitable. "It is to be expected," writes Professor Everett Hughes in whimsical vein, "that those who are subject to the same work risks will compose a collective rationale which they whistle to one another to keep up their courage and that they will build up collective defences against the lay world."[3] The professional association is useful because it claims the prerogative to define mistakes within the profession. And by and large "mistakes" are defined as violations of a code of ethics rather than as specific errors of judgment or even incompetence. Admission to a professional society is subject to an examination for competence. Thereafter membership in the society is contingent chiefly upon the member's complying with the code of professional ethics, and behaving in a dignified and honourable fashion.

Another motive for forming a professional association is that the association is an instrument for achieving a kind of social independence for the individual. It is worth something to be able to perform one's daily tasks in a field in which one and his fellow practitioners largely make the rules for themselves. The price of this distinction is, however, that the members subscribe to rules (ethics) which are several shades above those obtaining generally outside the profession. Otherwise the public would not tolerate such a state of affairs.

The Part Played by Bankruptcy Proceedings

The professional aspect of accountancy seems to have originated in Scotland where it was first regarded as an extension of the legal profession. The Scottish courts adopted the practice of engaging accountants to manage the estates of bankrupts, infants, lunatics, and others regarded as incapable of managing their own affairs.[4] The nature of these engagements was conducive to development of a profession in several respects. The engagements were *ad hoc;* that is, the

[2] From "South Sea House" cited by Mary Murphy, "The Rise of the Profession of Accountancy in England", *The Accounting Review,* March 1940.

[3] Everett C. Hughes, "Mistakes at Work", *The Canadian Journal of Economics and Political Science,* August 1951, p. 321.

[4] See Carr-Saunders and Wilson, "The Professions", pp. 209-219.

accountant was not in the continuous employment of any one person or company but depended for his livelihood upon a succession of separate engagements from various sources. Furthermore, the nature of the work called for a considerable knowledgeability, and also for integrity, because the accountant would have control over the property he was managing. When considering a career for his nephew Sir Walter Scott wrote as early as 1820 that he thought the nephew could not follow a better line than that of accountant which he described as being associated with "other branches of our legal trade".[5]

In view of the early association with what was largely a legal problem, it is not difficult to see how British accountants came to assume some of the already matured characteristics of the legal profession, particularly in the matter of ethics and apprenticeship.

The administration of the affairs of bankrupts and lunatics, and other legally defunct persons, could well have been a specialized legal problem. But the bankruptcy of a joint stock company was a different matter. It posed a more complex financial problem. Furthermore the bankruptcy of a joint stock company, particularly in the days before limited liability, spread over a wide area of the community into the homes of shareholders. A bankruptcy of this sort could be a public scandal, and the aftermath of ill-advised speculation, a national calamity. There is on record a report of Charles Snell of London following an examination by him of the books of a subsidiary of the South Sea Company which failed in 1720.[6] It is the first auditor's report on record — surely a collector's item!

The techniques of early professional accountancy were therefore somewhat lugubrious; something in the nature of performing a post-mortem on the records of a defunct business. Indeed, a certain stigma attached to the accountant because of his early association with bankruptcies. Even late in the nineteenth century when a British accountant was called for consultation to a client's office he might think it appropriate to disguise himself, or sneak in by the back door, for fear someone would recognize him and spread a rumour that the client was in financial difficulties.[7]

The Part Played by Limited Liability

The joint stock company could be incorporated with much less formality after the English Companies Act of 1862. Furthermore, the Act provided a means by which the shareholders of a company might have limited liability. After a few bankruptcies in which shareholders were impoverished because their company did not enjoy this privilege, it became impossible to float stock when the company was not "limited".

The conservative view towards the introduction of the limited liability feature was that it would promote irresponsibility in the management of company affairs. The English Companies Act of 1862 did not require an audit of limited companies but there were many who saw the need for an outside and independent check on the operations of limited companies. A prominent Englishman expressed himself thus: "In this age of joint stock companies we required men who drew themselves apart, who refused to touch profits, who took fees for their services independent of the size of the business with which they were associated,

[5] *ibid*, p. 209.

[6] See Arch Rounsaville, "Some Little Known Facts About How Accountancy got to be What it is Today", *The Journal of Accountancy*, Sept. 1949, p. 233.

[7] See Sir Laurence Halsey, "The Position of the Public Accountant in Relation to Business and Government in Great Britain". *The Journal of Accountancy*, Sept 1938. p. 17.

whose main aim and function in life was to keep to essential truths . . . Bankruptcy had lost half its terrors with limited liability. Limited liability meant that nobody was especially responsible."[8]

Joint stock operations with limited liability for stockholders made business possible on a larger scale than ever before. While the typical business unit was small the owner could, and did, take a direct interest in management. He controlled the buying, selling, and accounting policies of the business.[9] With the development of the large business unit these functions have had to be separated and delegated to specialists. Moreover, the owners could no longer be personally acquainted with all the aspects of the business. Neither could the company directors, representing the shareholders, nor the company officials appointed by the directors. What was required was, first, an efficient method of recording a mass of business transactions — for which the double entry system was available — and, secondly, a method of communicating the gist of that information both to management and shareholders. The auditor who acted for several businesses had an experience that was invaluable in suggesting improvements in accounting systems, and in the course of his practice he had often to reflect upon the means of presenting financial information to those who did not know the mystery of debits and credits.

With the joint stock form of business organization the management and ownership functions no longer resided in the same persons. Accordingly there could be a conflict of interest between management and shareholders. At first the stewardship of management was tested by an auditing committee of shareholders. Later the committee was replaced by an independent professional auditor.[10]

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Accountancy is distinguished from the older professions such as medicine and law in that it developed from the beginning largely as a service to business enterprises rather than to individuals. From the beginning, therefore, public accountants have practised as partnership firms, often employing large staffs. The typical large business enterprise is responsible for such a number of individual transactions within a year as to defy a complete, detailed audit. An important part of the senior accountant's work is to decide how much work will constitute an adequate examination of the accounts. Even on these substantially reduced terms, a large audit staff is often required.

The forces which led to the development of the joint stock form of business enterprise, and of limited liability, began to make themselves felt in earnest in the accountancy profession after about 1880. The new areas being opened up in Canada, and the new industries springing up in the United States were financed in part by British capital. To the economic separation of management and ownership was added a considerable phy-

[8] Sir Halford J. Mackender, quoted in *The Journal of Accountancy*, May 1922, p. 357.

[9] See Victor F. Stempf, "Trends in Accounting Procedure", *The Journal of Accountancy*, June 1940, p. 457.

[10] See A. C. Littleton, "Auditor Independence", *The Journal of Accountancy*, April 1935.

sical distance; and British capitalists sent out accountants to report back on the affairs of U.S. companies in which they held the majority stock. From all accounts the humble American accountant-bookkeeper of that day had his eyes opened by the decorum and general bearing of his British counterpart.[11] It was also a period of emigration from Britain to Canada, and both English and Scottish accountants came to make Canada their permanent home. From the Canadian point of view this movement can be explained by the understandable desire to get away from the system based on pounds, shillings, and pence.

The Increasing Interest in Costs

The accountancy profession on this continent became firmly established in the period 1890-1910. The building, extension, and grouping of railways, the amalgamation and consolidation of companies, and the developing techniques of mass production all inspired an interest in *costs*. It was a period of experiment in the relationship between costs and the scale of operations, and the services of accountants were required to determine costs. It was a period of the industrial engineer, of the efficiency expert, and of scientific management. When several concerns in the same line of business were brought together, there was an immediate interest in their respective unit costs of production and why the differences existed.[12]

In the United States no sooner had one set of accountants engineered the amalgamations of the period 1890-1910 when another set of accountants was required to assist in the trust-busting crusade. It seemed that accountants had been unwittingly cooperating with one another. The relationship between prices charged to consumers and costs of production took on a public character. A new era had dawned in which accounting regulations were to be used to "accomplish social objectives". In 1906 the Interstate Commerce Commission was given authority to standardize the reports of all railways coming within its jurisdiction.[13]

The Increasing Interest in the Measurement of Income

When a country is developing rapidly, as was true of both Canada and the United States in the early years of this century, investment is made for appreciation and not for a steady return of income. In this stage the balance sheet has a significance it does not have in a more mature economy. After things settle down the measurement of income, rather than the appreciation of assets, becomes the criterion of success in business ventures.[14]

On the other hand things never have quite settled down since the early years of this century. It was a succession of other events that changed the emphasis away from the statement of assets and liabilities to the statement of income. Foremost among these events was the raising of income tax to significant levels in the first world war. Particularly in the United States, where an independent audit of limited companies was not as a general rule required by statute, many concerns required the services of the public accountant for the first time to compute income tax. And, sad to relate, many business men became seriously interested in income only when

[11] See James T. Anyon, "Early Days of American Accountancy", *The Journal of Accountancy*, March 1925, p. 163.

[12] See E. L. Suffern, "The Accountant; Today and Yesterday" cited in an editorial, *The Journal of Accountancy*, June 1925.

[13] See Percival F. Brundage, "Milestones on the Paths of Accounting" *Harvard Business Review*, July 1951.

[14] See S. J. Broad, "The Development of Accounting Standards to Meet Changing Economic Conditions", *The Journal of Accountancy*, May 1949.

faced with the prospect of having it reduced by income tax.

Income tax has undoubtedly been a major factor in the rapid growth of the accountancy profession. But it has not been an unmixed blessing. In the United States especially, the dividing line between the work of the accountant and the work of the lawyer became a source of mutual embarrassment — and sometimes of mutual recriminations. Furthermore, in Britain, Canada, and the United States the new accounting objective of the measurement of income has had constantly to run the gauntlet of income tax rules, designed more for expediting collection of the tax and preventing evasion than for reflecting the most meaningful measure of business income. A great lesson of accountancy is that the measurement of income does not lend itself to blanket rules, but is subject to special considerations in the individual case.

But while the significance of income measurement increased, the balance sheet remained the respected document throughout the 1920's. This was perhaps partly attributable to the fact that the twenties were a period of economic development and of appreciation in the value of business assets. But the continuing importance of the balance sheet was also attributable to the attitude of bankers. Bankers placed much reliance on the working capital position disclosed by a business on its balance sheet in deciding whether to extend credit to the business. The result was that the business which needed bank credit most had most difficulty in obtaining it. Bankers were especially sympathetic with concerns which they believed were stating their assets on the conservative side — only the financially strong could afford to do that. It was generally accepted that an unqualified report of an independent public accountant indicated that the assets were at least not overstated. An audit of accounts intended for bankers' eyes was a type of engagement to encourage the conservative instincts of the professional accountant.

On the other hand there were powerful forces at work in the other direction, forces which lured the less resolute of accountants into the never-never land of appraisals. The late twenties were years of unbounded optimism and rising prices. Accountants were prevailed upon to acquiesce in appraisal of fixed assets which had been in use for some time, and in their re-statement at higher figures.

The depression which followed was a time of general disillusionment. The banker who had liked his assets on the conservative side, and the accountant who had journeyed into the far country and lived among the appraisers, had occasion to commiserate with each other in mutual misery. The depression brought home to each alike the truth that the worth of a business is best measured in terms of what profit the business can earn. The assets of the business, no matter how reported, become small consolation in the face of the inability to operate successfully. And so many business assets were written down again in the thirties and some, we must note with regret, were written off completely.

The Part Played by Public Distrust of Business Motives

The scandal of the stock market crash, as well as the individual scandals of fraud exposed in the aftermath, such as the Kreuger and Toll collapse (affecting many American and British investors) and the *Royal Mail Steam Packet* case in England, profoundly influenced the accountancy profession. Dissatisfaction with business methods was as widespread as the losses sustained. In Britain the failure to disclose the purposes to which

secret reserves were put, if not the propriety of the secret reserves themselves, was at length exposed for the mischief it was. In Canada a new Companies Act (1934) contained careful provisions regulating the issue of a prospectus inviting public subscription to stock, for the framers of that statute had sniffed some of the pungent aroma of the Royal Mail Steam Packet case which had drifted across the Atlantic. In the United States indignant investors were calmed first with a federal Securities Act (1933) and then with the Securities and Exchange Commission (1934).

The thirties were years in which business was suspect and in which, as a result, the public interest in prices and costs was intensified. Prices and costs became "affected with a public interest" as never before and whether accountants favoured the trend or not, their professional status must have risen for the fact: responsibility to the public (even though achieved by private practice) is a professional attribute. At the same time it became increasingly important that accountants be thought of as impartial observers by the public at large.

In 1939 the McKesson & Robbins scandal in the United States exposed the accountancy profession to front-page discussion in newspapers throughout the United States and Canada. With the Securities and Exchange Commission at its elbow, and the public at its throat, the profession in the United States rallied and entered a period of productive research that has made it the leader in accountancy thought throughout the world; but the effect of the S.E.C. and of the McKesson & Robbins fraud on the profession are matters of such importance that they properly belong to a separate discussion.

The Effect of the Second World War

The growth of the accountancy profession since the second world war has been phenomenal. Membership in the professional bodies in Canada and the United States has doubled in the last ten years. In 1942 there were 2,489 chartered accountants in Canada; in 1952, 4,975. The growth in the United States has been even more spectacular. In 1940 there were 5,437 members of the American Institute of Accountants; in 1950, 16,061; in 1952, 19,097.[15] This growth has its roots in the war period itself.

During the second world war the problem of determining costs for war contracts placed with private industry became important, and in addition income and excess profits taxes were raised to such a level that income tax law had to be made extremely complex to prevent great hardship in individual cases, and evasion in other cases.

Since the end of the war taxes have continued on a high level. But while tax problems are doubtless a part of the explanation of the recent growth of the profession they are not by any means the only explanation. The accountancy profession has been expanding into a vacuum which has been developing for some time. The business community has begun to value more highly the business know-how which the senior accountant acquires from his varied experiences and contacts. The senior accountant is in demand now not alone for his technical competence but for his advice. The thing which makes his advice especially valu-

[15] In the United States only about half of the certified public accountants belong to the national professional body. The number of C.P.A.'s in 1940 was 20,000; in 1951 it was 42,000. In England the growth in membership in the Institute of Chartered Accountants in England and Wales, and in the Society of Incorporated Accountants and Auditors, has been steady, but not as great. In the former body membership in 1938 was 12,568 and in 1949, 15,000.

able is that he has retained his independence and is able to give his opinion with some measure of detachment. Moreover, the old-time business executive who once prided himself on his snap decisions has had to reconcile himself reluctantly to the fact that he now lives in a more complicated world.

One of the criteria for professional status is that the practitioner should be called upon to exercise his judgment—a professional man does not follow mere formulae in the course of his work. The highest order of judgment required of him is the ability to diagnose cases. The lawyer has to decide whether a case is worth taking to court; the surgeon has to decide whether to operate, and perhaps more important, where to operate; the dentist has to decide whether to extract or fill. The professional accountant has had for some time to diagnose cases in deciding how much detailed checking is required in the face of the system of internal controls operating within the clients' business. In addition, the public accountant is now consulted for his opinion on business matters relating to office organization and efficiency and also on high level business policy.[16]

Some of the problems the profession has had to face since the end of the war have amounted to major challenges—challenges whether there existed an accounting theory adequate to provide the solutions. A problem arising at the end of the war was to decide whether the cost of reconversion to peace-time production, and of reorganizing sales departments, was in fact a cost of the war and properly a charge against the revenue of prior years, or whether it was a cost of the particular postwar years in which it was to materialize. Another problem was the result of trade union activity and required a difficult decision about how to record the effect of an introduction of employee pension plans. But chief among the problems has been a declining value of money of such proportions as to challenge the whole original cost basis of recording assets and measuring income.

This is not the place to discuss the *pros* and *cons* of converting accounting data to current dollars, but there is a side to the development of public accounting that partly explains the general unwillingness to change in the face of changes in the value of the dollar. One of the major contributions of public accountants in their role as auditors has been to require documentary evidence of business transactions.[17] It is difficult to appraise the role of public accountants in the development of the routine preparation of business papers to provide proof of the transactions which the records allege to have taken place; but doubtless the demands of auditors for proof of transactions have had much to do with modern office practice. The profession is built upon a foundation of business papers to substantiate historical business facts. To the accountant such facts are, for example, historical costs evidenced by invoices received from suppliers at the time the costs were incurred. Suggestions that some historical facts need modification to reflect the current financial position of a business tend to take the accountant out of his idiom. The accountancy profession reveres written evidence as does the legal profession. (We must note that an important element of opinion enters into the reporting of financial affairs in spite of the existence of business papers to prove transactions. But the exercise of opinion operates within a somewhat narrower frame of reference than

[16] See J. R. M. Wilson, "Chartered Accountancy as a Career", *The Financial Post*, Sept. 13, 1952.

[17] See A. C. Littleton, "The Uses of Theory", *The Journal of Accountancy*, April 1939.

it would if conversion to current dollars were made.)

Because the past ten years has been a period of far-reaching industrial expansion the balance sheet might have come into its own again as a measure of sharply increased asset values, but for several factors. In the first place business men and accountants had not forgotten the experience in the twenties and thirties with appraisals, and there was no general agreement, yet, at any rate, about the use of price indexes. In the second place, much of the expansion has been undertaken this time not by new companies financed by issues of stock, but by established companies through conversion of plant acquired during the war and by additional plant since acquired and financed by retained earnings. There have also been some new enterprises in the form of crown companies or government enterprises. Another reason is that, from an investor's point of view, the opportunity for appreciation in the value of stock has been much dampened by the inroads on profits made by wage and salary demands (on the part of both trade unions and management), and by income taxes.

There has of course been some kind of "appreciation" in this period of combined economic development and inflation; but it seems to have a meaning different from that which it had in the days when new enterprise was financed chiefly by stock issues. In any case the balance sheet has not returned to its former glory. The income statement continues as the financial statement on which interest centres. Current discussions about the effects on financial information of changes in the value of the dollar seem to have had more to do with converting costs to current dollars in computing profit than with recording appreciation of fixed assets, as such.

The Development of Accounting Principles

It must be true of all professional practitioners that, being concerned with a succession of individual cases, they work from the particular to the general. But in the older professions there has been an opportunity in the past to generalize. It seems that principles must slowly broaden down from precedent. Until the recent past the accountant has been left largely with a succession of individual experiences from which not much in common has emerged except an attempt on his part to provide a useful service at the time, plus a determination to remain independent. In a period in which practice precedes theory the public accountant's major contribution must be the integrity and independence which he brings to his work.[18]

The view that the only accounting theory is accounting practice is still held by some, though not by as many persons as formerly. A recent statement suggestive of this viewpoint is as follows: "Accounting is intellectual exercise but it is not *an* intellectual exercise. It is utilitarian. It is a language and a system of measurement. It is a body of convention and procedure and not a body of logic. Language is conventional and measurement is procedural. We are trying to transmit information; we are not investigating laws of nature, not constructing a science. It's an art, a means of expression."[19]

Because the accountant works with the particular, and has not had much time yet to generalize, he is prone to distrust other people's generalizations as they af-

[18] See H. D. Kerrigan, "Some Current Problems in the Teaching of Accounting", *The Accounting Review*, January 1952.

[19] Arthur M. Cannon, "Tax Pressures on Accounting Principles and Accountants' Independence", *The Accounting Review*, October 1952.

fect his work. Many accountants distrust index numbers, for example. They see limitations in the data of individual concerns and consider that general aggregates of data, being built up out of particular data, must obscure nearly everything which is meaningful.

For somewhat the same reason many accountants are distrustful of attempts on the part of government to regulate business (though government activities have provided accountants with a good deal of work). They see the ways in which business problems vary from concern to concern and in the course of their work encounter inequities in over-all regulations as they affect particular businesses.

If only the economic pot were allowed to simmer, the accountant might cook up something really delectable. The profession of accountancy has been called into existence on relatively short notice (the last 60 or 70 years) to meet an economic need. The profession has constantly had to adapt itself to changes in a period in which changes have taken place at an accelerating pace. For most of the period of its development the needs of business have called the tune.

As it appears from this point in time the period of rapid economic change has been working both ways. It has kept the public accountant preoccupied with new problems but it has also provided a considerable body of observations, observations of how the accountant reacts to problems, observations of what his process of reasoning is as he attempts to find a solution.

There is evidence now that out of the succession of specific problems faced in the past a body of generally accepted accounting standards may be developing. There have already been some attempts to formulate a set of accounting principles[20] but while the efforts were distinguished and stimulating their propositions remain a matter of widespread controversy. The task of formulating accounting principles is temporarily in abeyance and the profession has taken a different tack. Each of the professional bodies in England, United States, and Canada has at least one research committee which considers *specific* problems as they arise, and issues bulletins stating its opinions and recommendations.

The acting director and coordinator of research of the American Institute of Accountants expressed this objective as follows in 1939: "The present plan of the Committee [on Accounting Procedure] is to consider specific topics, first of all in relation to the existing state of practice, and to recommend, wherever possible, one or more alternative procedures as being definitely superior in its opinion to other procedures which have received a certain measure of recognition and, at the same time, to express itself adversely in regard to procedures which should in its opinion be regarded as unacceptable."[21]

It has only been in the past 25 years that the measurement of income has been recognized as the major accounting objective. This is short time by any professional standard to recognize, and become articulate about, the principles which decide the issues as they arise. The accountancy profession has entered an intermediate stage of development.[22] While it has not yet formulated an entire body of generally accepted principles, members have become critical of practice and have been able to decide in specific in-

[20] See Sanders, Hatfield and Moore, *A Statement of Accounting Principles* (The American Institute of Accountants, 1938) and Paton and Littleton, *Corporate Accounting Standards* (The American Accounting Association, 1940).

[21] from a letter by W. A. Hosmer, *The Journal of Accountancy*, April 1939, p. 240.

[22] See H. D. Kerrigan, *ibid.*

stances what they think is good or bad practice, as illustrated by the recommendations in the bulletins issued by the professional bodies.

Perhaps indeed the accountancy profession tends to exaggerate its inability as yet to establish "principles" compared with the other professions. When Justice Holmes made the remark that "the law is always approaching and never reaching consistency" he may have made a remark that was true of the theories underlying professional practice generally. An accountant has recently put the point this way: "It is impossible in any large group of individuals engaged in a common pursuit to obtain unanimous recognition of a set of principles, code of operation, rules of procedure, or other important formal statement intended to guide or direct the actions of the individuals. Like most legislation, such guiding or directing statement must be a compromise."[23]

There is in the area of the subconscious, in the area of the inarticulate, an intuitive process of reasoning given to those who have come through a succession of experiences. It appears that these people can reach decisions without being able to explain *why*, in so many words. It is evading the issue to say that for this reason the decision is necessarily irrational, or merely lucky. A former Governor of the Bank of England when asked to explain the basis of his reasoning in making technical decisions affecting the monetary policy of the Bank is said to have thrown up his hands and said that he did it "by feel and flair". In the United States the Federal Reserve Board managed to reach fairly unanimous decisions about changing the rate of discount from time to time for one of the Federal Reserve banks; but when a law was passed compelling the Board to explain the reasons for these changes the result was an odd assemblage of reasons from different members of the Board for the same decision.[24] We should not be surprised if there is often more of authoritative opinion than sweet reasonableness in the research bulletins of the professional societies.

In a profession like accountancy there may even be some advantage in not having thoroughly crystallized principles in black and white. Once principles are formulated and generally accepted they become "institutionalized" and difficult to revise.[25] One of the most characteristic aspects of the accountancy profession has been that it has developed in a period of rapid economic change and that its development has depended upon the usefulness of the services it could render under these circumstances.

In any case it would seem that for accountancy, experience is the stuff of which useful, working decisions are made. Here again there is a parallel with the law. Justice Cardozo has put the proposition this way: "The common law does not work from pre-established truths of universal and inflexible validity to conclusions derived from them deductively. Its method is inductive, and it draws its generalizations from particulars."[26] So it may well be, too, with accounting principles.

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[23] H. T. Scovill, "An Effort to Define Business Income", *The Accounting Review*, October 1952.

[24] See Annual Reports of the Board of Governors of the Federal Reserve System· Twenty-Second Annual Report (1935), page 52; and (as an example) Twenty-Third Annual Report (1936), pp. 216-219.

[25] See Calvin C. Potter, "The Economic Consequences of British Accountancy", *Accounting Research*, July 1951, p. 313.

[26] Justice Cardozo, "The Nature of the Judicial Process", cited by G. O. May, *The Journal of Accountancy*, Jan. 1940, p. 15.

The Impact of Income Taxes on Depreciation Accounting in Canada

By George G. Richardson, F.C.A.

Policy considerations impinge on accounting procedures when the government compels the two to be linked

AN examination of published financial statements of Canadian companies indicates that the basis of capital cost allowances now in effect for income tax purposes is having a considerable effect on depreciation accounting policies of Canadian companies, particularly in heavy industry.

Distinguishing Terms

These two terms are so often used interchangeably that it would be well to start by distinguishing between them.

Depreciation accounting has been defined by the Committee on Accounting Procedure of The American Institute of Accountants as follows:

> Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.
>
> Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.

Capital cost allowances, on the other hand, represent deductions in arriving at income taxable under the Income Tax Act. When applied to tangible assets these allowances may have a great deal in common with depreciation provisions (particularly if we overlook those cases where the capital cost allowances are based on quite different costs to previous owners from whom they were acquired in a purchase not at arms length). But they are undoubtedly influenced in an important degree by factors not recognized in the accepted definitions of depreciation accounting. Estimated useful life was undoubtedly a basic consideration in fixing capital cost allowances but a review of some of the events of recent years leads to the conclusion that these allowances are being used increasingly as an instrument of economic policy rather than as a strict counterpart of depreciation.

Recent Developments

Our pre-war system of allowances was generally speaking a scale of rates which were considered quite adequate in most

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circumstances, applied on a straight line basis. When an effort was made late in the nineteen thirties to encourage capital expansion it was not done by changing the rates but by permitting a system of tax credits known as "capital expenditure allowances" which gave deduction from taxes over a short period of years in addition to those resulting from the depreciation allowances.

The war period brought with it a number of unusual problems and resulted in allowances at a more rapid rate, some being based on increased use of the assets for extra shift operation, others being based on the assumption of limited usefulness in the post-war period. In both cases estimated useful life was still the primary factor in determining the increased allowances.

In the post-war period, on the other hand, fiscal policy has been an increasingly important factor. Four phases may be cited:

1. The so-called double depreciation by which double the usual rates were allowed on assets acquired shortly after the end of World War II in a period in which it was considered desirable to encourage capital expenditures.

2. As an anti-inflationary measure allowances were deferred on assets acquired subsequent to April 10, 1951, except when the expenditure met certain tests which would establish it as being in the national interest.

3. The introduction of much higher rates in 1949 (usually double the former rates) to be applied on the diminishing balance instead of on a straight line basis on the original cost. While the adoption of the diminishing balance basis was no doubt dictated by a number of considerations, it seems fair to conclude that one of the principal objectives was to develop a system which would permit deduction of a relatively large part of the cost of machinery and equipment over the first few years, while limiting the total allowance to actual cost.

4. The deduction of allowances for new plant not yet in service. The regulations governing capital cost allowances on plant coming into service during any year do not restrict the allowances to the period in which the plant was in service, nor do they prevent the deduction of such allowances during prior years when the plant was under construction.

The combined effect of the diminishing balance method, the relatively high rate allowed on a wide class of machinery and equipment and the absence of any restrictions against making deductions in respect of plant under construction is to permit the deduction, in arriving at taxable income, of a relatively large part of the cost of certain types of plant before it has been long in operation.

Income Tax Requirements

This liberalizing of the taxation allowance is, however, complicated by the regulations (s. 1100(4)) which require that in the case of resident corporations an amount equal to the allowances be charged in the accounts. The reason for this requirement is not clear, particularly in the light of the fact that the charge may be made either against income or surplus and either in the year or a preceding year, and thus does not carry the connotation that the directors have determined that it is a proper charge against the year's income. It is contrary to the policy followed in the case of allowances to the oil and gas industry for drilling and exploration. Such expenditures may be claimed up to the amount of income available in any year after they are made with no requirement as to the accounting treatment; usually they are capitalized in the accounts and are deducted for tax purposes in advance of being charged

to income. It is also contrary to the handling of deductions for capital expenditures on research which are not dependent on the bookkeeping followed.

The capital cost regulations have thus raised conflicting considerations for industry. Money is tight at present. The regulations permit of rather generous deductions from income and consequent tax reductions which will help to finance the expenditures in question. A quick write-off can be obtained for a large part of the equipment cost, a result which many businessmen consider to be highly desirable. To obtain this allowance it is only necessary that an amount within the stipulated rates be recorded in the accounts. It does not appear to be necessary to establish that it is either a necessary or proper charge under accepted accounting principles.

Canada's Position Unique

We in Canada have a rather unique problem in this respect. Our problems frequently parallel those in the United States, but the conditions prevailing in the U.S. in this respect are quite different. Where our regulations set up arbitrary classifications for various types of plant and fix a maximum rate of capital cost allowance to be applied to the diminishing balance in each class, the allowance for U.S. federal tax purposes have to be established by reference to the estimated lives of the assets. Bulletin F issued by the U.S. Bureau of Internal Revenue sets out what the administration considers to be average lives for many different kinds of plant classified by industry. These asset lives, generally speaking, result in considerably smaller allowances than either our present rates or the old straight line rates. They are not, however, considered to be the basis of a hard and fast rule nor is a method — straight line or otherwise — prescribed. Each taxpayer selects his own method and applies whatever rates he considers necessary and he must be prepared to justify his claim. Accordingly, the amounts allowable are probably no greater than would represent the necessary depreciation provisions under good accounting practice.

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Adoption of Diminishing Balance System

In a great many cases Canadian companies have adopted the diminishing balance method of depreciation for their corporate accounting purposes without any great effect on the amount of the charge for the year as compared with methods previously in use. When the plant in service includes a fair distribution of both newer and older plant, the application of rates corresponding to those allowed for tax purposes will frequently make an inconsequential change. Many statements have been issued in which attention has been called to the fact that a change has been made and indicating the effect of the change which was not great.

On the other hand some companies committed to large expenditures for new plant acquired at high prices have provided depreciation equal to the deduction allowable for tax purposes and thereby greatly increased their provision over what would be required on the basis of expected asset lives. I am not referring to emergency facilities where the provisions may be computed by reference to an expectation

of limited future usefulness when the emergency has passed, but rather to those companies which have adopted the deduction allowable for tax purposes as the measure of the provision to be made for depreciation in the accounts solely as a means of meeting the practical problem of getting a charge on the books so as to qualify for tax reductions.

Accounting Procedures Followed

The treatment of these additional provisions has been varied but two methods in particular may be cited:

1. The full amount of the increased provision, i.e. an amount equal to the maximum allowances deductible for tax purposes (including depreciation in respect of plant not yet in service) has been charged against income account and a statement has been made by way of footnote as to the amount of the increase in such charge over the former year's basis. Part of the increase in depreciation will, of course, be offset by a reduction in taxes and it is usual to state as well the resulting amount of decrease in the net profit.

2. Income has been charged with a normal provision for depreciation and taxes have been computed on the basis of the amount which would be payable if only that amount were deductible for tax purposes as a capital cost allowance. The excess over normal provision for depreciation is charged against earned surplus and there is credited to earned surplus the tax reduction which results from claiming the additional depreciation.

The first-mentioned method (under which the entire charge is made against income) relies on the footnote to set out the effect of the change in policy and to indicate what profit would be shown under conventional methods and with related taxes. The question as to whether the effect on future years' income of making additional provisions in earlier years will continue to be dealt with by way of footnote and whether this solution will prove generally satisfactory remains to be seen.

The second method avoids distortion of the income account in the years in which the excess provisions are made by segregating against surplus both the excess provision and the resulting tax reduction. Under this method the excess depreciation less related tax reduction has been charged against earned surplus and unless some technique is devised to deal with the situation it may never be deducted from the profits of a particular year.

Solution for the Accounting Problem

If the impact of capital cost allowances has resulted in a trend in our depreciation accounting which leaves something to be desired, the question arises as to whether the solution lies in the realm of accounting or whether it should be cured at the source by repeal of the regulation which requires the recording of amounts equal to the capital cost allowances as a condition to their deduction. As has already been stated, the reasons for the requirement are not clear and the requirement is not consistent with the position taken by the taxation authorities on related matters such as drilling and exploration costs of oil and gas companies. Repeal of the regulation would permit of a solution along the lines of the recommendations of the American Institute's recent bulletin #42 which deals with the situation arising from obtaining tax allowances for the cost of facilities acquired for defence production over a period shorter than the expected useful life during which they are being amortized in the accounts. The circumstances are thus basically similar to those

which would be found if regulation 1100(4) were repealed and the tax allowances claimed were in excess of the depreciation recorded.

Bulletin #42 recommends that in such cases the income for the year should not be inflated by including the tax reduction which results from claiming greater capital cost allowances than the amount of depreciation recorded in the accounts. The treatment recommended by the bulletin is to make provision out of income for an amount corresponding to this reduction as a provision for future income taxes which will presumably be payable at such time as depreciation is provided which is not allowable for tax purposes. While this course prevents the inflation of the income account in this respect, it has the effect of providing an amount in respect of future taxes which is not a liability and which may never become a liability.

An alternative treatment which bulletin #42 recognizes as acceptable is to provide additional depreciation instead of the provision for future taxes. This additional depreciation charge would be a practical means of recognizing the fact that part of the book value will not be deductible for tax purposes in future.

If, therefore, regulation 1100(4) were repealed and a company were free to deduct capital cost allowances of any amount for which it was otherwise eligible without recording corresponding amounts in the books, it should not be difficult to find a satisfactory means by which the charge for depreciation could be restricted to a proper figure on an age-life basis without inflating the income account by tax saving. Whether the repeal of this section would, on balance, contribute to an improvement in accounting may be debatable. It could create more problems than it would solve. In any event it is not a solution which is in the hands of the accountant.

Some Observations

The Institute's Committee on Accounting and Auditing Research has been considering the accounting problems which are indicated by present trends in practice to which reference has been made. No conclusions have been reached as yet and accordingly none of us can speak for the committee. However, it may contribute to our discussion if I make these further observations:

1. Our primary concern is, I think, the income statement. In the balance sheet fixed assets represent basically costs chargeable to future periods not necessarily related to present values and as such are of limited significance from the standpoint of the financial position.

2. Our whole accounting structure, so far as fixed assets is concerned, has rested in the conception of depreciation accounting as a method of amortizing the cost over the useful life of the assets. The principle has been clearly spelled out as one of amortization, not of valuation; likewise it is to be rational and systematic, not fortuitous or dependent upon extraneous factors such as the amount deductible for tax purposes. If the determination of income is to be made objectively it must be based on some such principles. The problem then becomes a question as to whether the methods which have been adopted to date to obtain increased tax allowances or others which might be devised are acceptable methods of applying the established principles.

3. The profession in the English speaking world has not as yet recognized a departure from the concept of depreciation as being an amortization of cost: consequently any increase in depreciation provisions cannot under presently accepted principles be justified on the basis of the changing value of the dollar.

4. The diminishing balance method as such is in my view an acceptable method. While it has been much less commonly used in the past than the straight line method, it has certain characteristics to commend it. The straight line method is probably founded largely on simplicity. If it had to be justified on any presumption as to the exhaustion of its utility value, the implication of equal utility in each year for a stated period and then a sudden expiry of utility value would rarely correspond with the facts. Increasing obsolescence due to technological improvements and other factors and the uncertainty of future product demands provide sound arguments in many cases for some modification of the straight line method.

5. If additional provision for depreciation in excess of normal is made as a charge against surplus, any reduction in tax which results from claiming a corresponding additional amount as capital cost allowances should be credited to earned surplus and not included in arriving at the net income of the year. This would be a logical application of the principle of allocating income taxes already adopted by the American Institute.

6. Where material amounts of additional depreciation are charged against income or surplus, consideration should be given to the development of accounting techniques which would ensure that the income account in future years would not be relieved as a result of these charges.

WINNIPEGGERS LEAD THREE PROFESSIONS THIS YEAR

The current presidents of three of Canada's national associations are residents of Winnipeg. They are Dr. C. W. Burns, president of the Canadian Medical Association; Mr. John MacAulay, president of the Canadian Bar Association; and Mr. Walter J. Macdonald, this year's president of the Canadian Institute of Chartered Accountants.

Accounting Provisions For a Uniform Companies Act

By T. A. M. Hutchison, F.C.A.

An explanation of the C.I.C.A. recommendations for amendment of the Companies Act

THE subject "Accounting Requirements for a Uniform Companies Act" stems directly from the report of the special Companies Act Committee of the Canadian Institute of Chartered Accountants which was published in the April issue of *The Canadian Chartered Accountant.*

I think it might be worthwhile to give as briefly as possible some of the background for the report. All the provincial Institutes were asked in 1950 to consider the question of amendments which we, as a profession, might consider desirable in the Companies Acts now in force in Canada. In due course their reports were forwarded to the C.I.C.A. who set up a small working committee composed entirely of Toronto residents because it was felt that with a large number of meetings to be held, the membership must be local. However, we realized the disadvantage of confining the membership in this way and to get around the difficulty in part a preliminary report was made in the summer of 1952 and circulated to all provincial Institutes, with a request for criticisms or suggestions. The final report can, therefore I think, properly be considered representative of the profession in Canada.

Last October the committee was asked to appear before the Dominion-Provincial Conference on Company Law in Ottawa where a one-week meeting was held between members of the Departments of the Secretary of State and of the various Provincial Secretaries. Our initial introduction to this committee was a pleasant one as Monsieur Parent, a Federal M.P. sitting unofficially as an observer from Quebec, opened the proceedings by remarking that the American standards of disclosure and the proposed standards of the chartered accountants were much higher than the present ones of Canada. The situation in Canada, he said, was like a masquerade ball — everything was hidden, but with the new standards it would be like a debutante's ball — you saw everything!

Report of the Committee

The report on the Companies Act was broken up into five divisions: *books and records, annual accounts, auditors and their report, prospectus provisions, and miscellaneous.* The changes proposed for annual accounts and auditors and

A paper read to the 51st annual meeting of the C.I.C.A., Victoria, September 9, 1953

their report are of most importance to us and my remarks are, therefore, mainly directed at these divisions.

Books and Records

The changes proposed in the requirements for books and records to be kept by a company are minor. One proposed change is to alter the term "books of account" to "accounting records" because some modern accounting records might be difficult to describe as books of account. The other main recommendations were designed to give legal permission to a company to keep at any place it carries on business, such as a branch, that part of its accounting records as relate thereto so long as adequate records are kept at the head office. Permission is also to be given for accounting records to be kept at some place other than the head office subject to obtaining approval from the governmental authorities involved.

Annual Accounts

This title covers the statements which are to be presented to shareholders as well as the requirements for disclosure. It is proposed that every company must present a statement of profit and loss, a statement of surplus and a balance sheet. A provision is also contained, however, to permit other terms to be used to describe these statements: for instance, if desired, "statement of financial condition" might be used instead of the term "balance sheet". It is also proposed that a period of six months after the end of a company's financial year be allowed to present the financial statements at an annual meeting instead of the present requirement for most companies under the Dominion Companies Act of four months; it was felt that with the increasing size and complexity of business it was desirable to allow some additional leeway in time.

Definitions

Two matters of prime importance in setting out requirements for financial disclosure were found to be the existence of and movement in reserves, that is reserves as accountants understand the meaning of that term, and the relationship of holding, subsidiary, and affiliated companies. To cover these two matters we believed it was necessary to define reserves and subsidiary and affiliated companies which was done in the form of two recommended provisions.

In defining reserves the recommendations in Bulletin No. 9 of the C.I.C.A. were used as a basis. The proposed definition provides that the term "reserve" shall only be used in financial statements to describe amounts appropriated from surplus either at the discretion of management or under by-law provisions or terms of a contract such as a debenture trust deed and where such appropriations are not to meet a known liability or a decline in value of an asset. For instance a "reserve for future replacement of fixed assets at higher cost" would be considered a reserve but an allowance for depreciation of fixed assets, frequently called a reserve for depreciation, would not be described as a reserve under the proposed revision.

The provision dealing with subsidiary and affiliated companies sets out in effect that a company is a subsidiary of another company if it is controlled by it or by a company which it in turn controls, and that a company is affiliated to another company if both companies are subject to the same control, whether control is exercised by another company or by a person. Control is then defined as the holding of shares carrying more than 50% of the votes for the election of directors together with the power to elect a majority of the Board.

Since financial statements will often be presented in a consolidated form, the

actual wording of the recommendations has been designed to fit the circumstances where statements are presented in either consolidated or unconsolidated form.

Financial Statements

In the preamble to each recommendation on the financial statements the requirement is set out that the statement shall be drawn up so as to *present fairly* the results of operations in the case of the statement of profit and loss, the transactions in the case of the statement of surplus, and the financial position in the case of the balance sheet. The phrase "presents fairly" seemed to us less stilted and at the same time to be a better description of what the statements are intended to do, being open to a broader interpretation than the words "true and correct" presently in use in Canada.

Statement of Profit and Loss

The proposed disclosure requirements for the statement of profit and loss do not differ too materially from those in the present Dominion Companies Act. One principal change was to divide the income from investments into three parts, from subsidiaries, from affiliated companies other than subsidiaries, and from other sources. This was obviously necessary in order to have a proper picture of the source of a company's investment income and to relate the dividend income of subsidiaries and affiliated companies to their actual earnings.

One point, on which we received some criticism, was the failure to require disclosure of the sales of a company. When the form of the profit and loss statement was first considered this matter was one of the more difficult to decide but our final view was that the sales figure was not essential to a fair presentation of the operating results of a company and that under some circumstances it could be most unfair as between competitors.

Mr. T. A. M. Hutchison, F.C.A. was born in Vancouver but educated in England. In 1925 he joined Peat, Marwick, Mitchell & Co. and has practised in Vancouver, Calgary and Toronto. He has been a partner of the firm for some years. A member of the Alberta and Ontario Institutes, he was made a Fellow of the Ontario Institute in 1947. He is chairman of the Canadian Tax Foundation and treasurer of the C.I.C.A.

Statement of Surplus

In considering the form for the statement of surplus the first conclusion reached was that the terms "capital surplus", "appraisal surplus", etc. were generally confusing; often capital surplus included profits on sales of fixed and other capital assets whereas in fact the profits had been realized and should be regarded as part of earned surplus. Following from that thought we believed that in virtually all cases surplus could be segregated into earned surplus and contributed surplus. Contributed surplus would be built up from premiums received on issues of capital stock, donations of assets by shareholders, alterations of capital stock and similar items directly related to the shareholders' contribution, while all other items such as net profits, profits on sales of capital assets, reserve transfers, and dividends paid would fall into the earned surplus. The proposed requirements for the statement of surplus therefore divided surplus into two parts, earned and contributed, and then called in each case for disclosure of the opening balance, particulars of transactions and changes affecting surplus during the year, and the closing balance.

Balance Sheet

The balance sheet disclosure require-

ments go some distance beyond those in the present Dominion Companies Act but do not, I believe, go beyond what would be considered a proper presentation by most accountants. I propose, therefore, to mention only a few of the main additional requirements.

Debts owing to a company are to be segregated between subsidiaries, affiliated companies, and ordinary trade debtors, also loans and overdue trade accounts due from directors, officers and shareholders. A similar form of segregation is required for debts owing by a company. Investments in securities are to be shown under the headings of subsidiaries, affiliated companies, and all other securities, with information where available as to the market value of the other securities. You will note in each case that the investment in both securities of and advances to subsidiaries and affiliated companies, and the liabilities to such companies, are shown separately so that there is a clear picture of the inter-company financial relationship.

Contributed surplus and earned surplus are to be shown separately, thus tying them into the statement of surplus. Reserves which, as already mentioned, are specifically defined in the recommendations are to be set out showing any amounts added to or deducted from the reserves during the financial year.

Notes to Financial Statements

The practice of disclosing information on financial statements by means of notes is becoming more and more common with the increasing complexity of business, and specific permission is to be given to show explanatory information or particulars in this manner. At the same time there are a number of matters which need special disclosure in financial statements but which would not necessarily be called for under a particular profit and loss or balance sheet heading. Our recommendations, therefore, call for disclosure of the more important and commonly encountered matters of this kind either by way of a note or by incorporation in the body of the statement.

The most important of these recommendations was probably the requirement to show by way of note particulars of any change in accounting principle or practice or in the method of their application which would affect comparability of any of the statements with those for the preceding year and the effect on the profit or loss for the year. The reason for this is obvious since if financial statements are to be drawn up so as to present fairly the operating results and financial position of a company and in a manner where intelligent use of the statements can be made, it must be possible to compare them with those of the preceding year.

The other recommendations, some 13 in number, call for disclosure of matters such as the basis of foreign exchange conversion and foreign exchange restrictions, contractual obligations for abnormal expenditures and long-term leases, contingent liabilities, options granted on shares of the company, and similar information. They also call for information on remuneration of directors of a holding company paid to them by a subsidiary whose financial statement is not consolidated and for the amount of any loans made during the year by the company or any subsidiary to any director or officer of the company. Another requirement in the case of a holding company is the disclosure of particulars of any of its securities held by any subsidiary whose financial statement is not consolidated.

All notes to financial statements are to be considered an integral part of the financial statements and thus are specifically part of the statements on which the auditor must express his opinion.

Holding Companies

I now come to what were probably the most important disclosure requirements in our recommendations, namely those dealing with consolidated financial statements for holding companies and the information to be provided if consolidated financial statements are not presented. In most cases consolidated financial statements will provide the fairest presentation of information for a holding company. There are, however, instances where this is not the case, for instance where the holding company is a manufacturer and a subsidiary is in an entirely unrelated kind of business such as the financing of acceptances, or where foreign exchange restrictions affect the availability of the assets of the subsidiary or where the holding company's interest in the subsidiary is subject to the prior claim of issues of securities of the subsidiary such as bonds and preferred shares. For these reasons it would be undesirable for the presentation of consolidated statements to be made compulsory.

The first recommendation on this point did not in fact represent any change from the existing situation under the Dominion Companies Act which allows any holding company to submit consolidated financial statements with any one or more of its subsidiaries, making due provision for minority interests.

Where any subsidiary is not included in a consolidated financial statement the committee recommends that a statement is to be annexed to the financial statements of the holding company setting out the following information for the unconsolidated subsidiary or subsidiaries:

First, the reason for not consolidating.

Second, the aggregate amount of the holding company's proportion of the profits or losses of the subsidiaries for the current financial year.

Third, the amount of income received from the subsidiaries or the provision for loss which is included in the holding company's statement.

Fourth, the aggregate amount of the undistributed profits or losses of the subsidiaries accumulated since the acquisition of the shares of the subsidiaries.

Fifth, any qualification in the auditors' report or note on the financial statements of the subsidiary unless the matter has been dealt with by provision in the holding company's financial statements.

The present Dominion Companies Act requires disclosure of any qualification in an auditors' report on a subsidiary in much the same manner but the information to be given as to profits of an unconsolidated subsidiary is, to say the least, inadequate. The Act in effect only requires that a statement shall be made as to how the profits or losses of the unconsolidated subsidiaries have been reflected in the accounts of the holding company. Further, while the amount of the aggregate losses less profits of subsidiaries, if not provided for in the holding company's accounts, must be revealed, the Act specifically states that it shall not be necessary to state the actual amounts of the profits or losses. Specific permission to omit disclosing the amounts of profits of subsidiaries gives legal sanction to nondisclosure of information that may be vital to any clear understanding of the affairs of a group of companies.

By combining the special information required for unconsolidated subsidiaries with that called for in the disclosure requirements for the statement of profit and loss, balance sheet and notes to financial statements, where the income from and investment in securities of and advances to subsidiaries must be shown, a reasonably clear picture can be obtained, particularly of the earnings of the group. We gave a good deal of thought to requiring that the financial statements of unconsolidated subsidiaries must be pub-

lished separately, but we came to the conclusion that this was too burdensome a requirement since the essential information as to the earnings of subsidiaries would be given under our recommendations. It might also well result in subsidiaries being consolidated in order to avoid publishing a separate statement when the circumstances made consolidation highly undesirable.

The suggestion has been made that private companies should not be made subject to the same disclosure requirements as public companies. Since there are often minority interests in private companies who should receive adequate disclosure of financial information, we could see no good reason why private companies should not adhere to the same standards as public companies.

Auditors and the Auditors' Report

Dealing with the appointment of auditors and their qualifications and duties, the changes recommended were relatively minor. The following are the more interesting:—

The present Act makes no provision for the removal of an auditor, and it is proposed that this should be permitted by a two-thirds majority of votes of shareholders at a special meeting.

In the case of a private company, a director, officer, or employee will only be able to be appointed auditor upon a unanimous vote of the shareholders at the meeting. Furthermore this right would be denied to a private company which is a subsidiary of a Canadian public company since a subsidiary is generally only an extension of the parent company's undertaking and it would be unreasonable to permit the audit of its accounts by a non-independent party.

The present Dominion Companies Act only requires the auditor to make a report on the accounts he examined and on the balance sheet to be submitted to the shareholders. The auditor is also required to state whether or not all information and explanations required have been obtained and the balance sheet is as shown by the books. The most important statement submitted to shareholders is probably that of earnings and no specific requirement is laid on the auditor to report on the statement of profit and loss.

The committee felt that the requirement to make an examination of "accounts" might be too narrow since it might imply that the auditor need not go behind the accounts, whereas in fact examinations are normally extended beyond this area, for instance the practice of observing the physical inventory-taking is now often followed. Accordingly, under our recommendation the auditor is to make such examination as will enable him to report to the shareholders under the Act and the extent of this examination is left to the auditor's judgment.

The duties to be laid on the auditor under the recommendations are:—

First, as I have already mentioned to make such examination as will enable him to report on the financial statements,

Second, to make a report stating whether the financial statements present fairly the financial position of the company and the results of its operations for the year, and

Third, to make such statement as he considers necessary if the financial statements are not in agreement with the books or in accordance with the requirements of the Act, if he has not received all the information and explanations required and if proper accounting records have not been kept.

It is important to note that the third set of statements are only to be made in certain specified circumstances so that in nearly all cases the auditors' report can be a brief statement as to the extent of

his examination and of his opinion on the financial statements.

Accounting Provisions in Connection with a Prospectus

In dealing with the subject of prospectuses I intend to be brief because the Companies Act provisions are no longer of as much importance because most of the Provinces have special legislation dealing with the sale of securities.

The more important recommendations as to changes propose that it should be compulsory that a prospectus contain financial statements, that the balance sheet should be in the form prescribed for the balance sheet to be submitted to the shareholders at the annual meeting and that an earnings statement should be included covering a period of at least five years as against the present requirement of three years. The earnings statement is to conform to certain minimum standards of information which are similar to those generally found in an earnings statement in a Canadian prospectus, namely the operating profit, depreciation and depletion, interest on long term indebtedness, taxes on income, provision for minority interests in subsidiaries, the net profit or loss and particulars of any important non-recurring charges or credits. An interesting additional requirement is that any change in an accounting principle or practice which affects the comparability of the earnings between years must be reported.

Where a business is being acquired with part of the proceeds of an issue, an earnings statement for a five-year period and a balance sheet of the business to be acquired is to be presented or a pro forma earnings statement for a five-year period and a pro forma balance sheet combining the assets, liabilities and earnings for the business being acquired with those of the company issuing the securities.

Since, as already mentioned, the presentation of consolidated financial statements is not always the best way to show the clearest picture of a business undertaking, it is proposed that instead of having consolidation mandatory as under the present prospectus provisions of the Dominion Companies Act it should be necessary to present the following information for unconsolidated subsidiaries:—

First, particulars of earnings in the form prescribed for similar statements for the company issuing the securities, and

Second, to provide practically the same information required for unconsolidated subsidiaries in annual financial statements.

Miscellaneous Matters

While the miscellaneous matters dealt with are not entirely relevant to accounting requirements I think they are well worth study as they cover problems and matters which our profession often encounters. Since some of the matters dealt with are relatively unimportant I am confining my remarks at this time to two or three of the more interesting points.

Distributable Surplus

The present Dominion Companies Act permits the directors of a company to set aside as distributable surplus:

First, an amount up to 25% of the consideration received for no par value shares, and

Second, where a going concern is acquired by the issue of no par value shares, an amount up to the balance of the earned surplus at the time of acquisition.

Our general feeling was that there was no good reason to permit consideration received for the issue of shares to be set aside as distributable surplus. Our recommendations were framed accordingly, and in particular where a going concern is acquired, to withdraw the power

to set aside as distributable surplus the earned surplus of such concern.

Capital Surplus on Redemption of Preferred Shares

The present provisions of the Dominion Companies Act can be interpreted as requiring a transfer from earned surplus to capital surplus of an amount equal to the par or stated value of preferred shares redeemed except where redemption is made from the proceeds of a new issue of shares. This procedure is cumbersome and causes considerable difficulty when a company takes advantage of the new provisions of the Income Tax Act permitting capitalization of undistributed income by means of stock dividends, since the mechanics of making the distribution usually necessitate payment in the form of redeemable preferred shares with subsequent redemption. Since the main purpose of this provision would seem to be the protection of creditors by preventing any impairment of a company's capital we proposed that this should be accomplished, without the present procedure, by providing that preferred shares cannot be redeemed when a company is insolvent or when the redemption would make the company insolvent.

Disclosure of Security Transactions of Directors

The requirements of the Dominion Companies Act at the present time are that at each annual general meeting every director of a public company must furnish a statement setting out his transactions in the securities of the company during the preceding twelve months. In addition directors of a public company are prohibited from speculating in the securities of the company.

The prohibition as to speculation seemed to us of doubtful value because it is almost impossible to decide whether the director is investing or speculating when he purchases securities of the company. We came to the conclusion that the best protection for the shareholders was adequate disclosure of security transactions and that such disclosure should be more frequent than once a year. We also felt that it was almost as important to disclose transactions in securities of subsidiary companies.

Our recommendation was therefore framed to require every director to furnish to the secretary of the company particulars of any transactions in the securities of the company or of any subsidiary within 90 days of the transactions. The secretary was then to be required to record this information in a book which would be open to inspection by any shareholder of the company during normal business hours.

Acquisition of Shares of a Parent Company by an Affiliate

There have been instances where shares of a parent company have been purchased by a subsidiary and a subsidiary occasionally is acquired which already owns shares in the company acquiring control. Since the subsidiary is in effect only an extension of the parent company, this is the equivalent of a company purchasing its own shares. It was therefore our opinion that a subsidiary should be prohibited from acquiring shares in a parent company. In cases where a subsidiary already holds shares in the parent company, we felt that, while it would be too onerous to require the sale of such shares, at least the shares should be deprived of voting rights.

The new British Companies Act contains a provision which gives effect to our views on this matter, and we recommended enactment of a similar provision.

Amalgamation of Companies

For many years the Ontario Companies Act has contained a provision which per-

mits the amalgamation into one corporation of two or more companies which have similar objects. Where the shareholders of companies wish to pool their interests, it is generally necessary without this provision to form a holding company to own the shares of the companies involved or to transfer the assets of the companies to a new company followed by the winding up of the former. As we all know, these steps create problems under the Income Tax Act in dealing with the undistributed income of the companies if controlled by a new holding company or if they are wound up. In practice the Ontario provision has been found useful as it permits companies to merge and pool their interests without eliminating their existing surpluses and it obviates the necessity to transfer assets from one company to another. We therefore recommended the inclusion of a similar provision in the Companies Act.

Summing up, I think it is evident that the recommendations in the report call for much fuller disclosure of financial information in company statements than has been required by any Canadian Companies Act. I use the words "has been" because the Province of Ontario has within the last few months passed a new Act to come into force next April 30 which embodies virtually all the recommendations of the report with only minor changes in wording except for the portion dealing with prospectuses which is covered in Ontario under the Securities Act.

Accounting Judgment

In describing the extent of the disclosure requirements, I think it could be said that we have attempted to set out what must be disclosed without specifying how it should be done or venturing into the field of applying accounting principles. The thinking behind this is that the Act should spell out what must be said but the professional accountant should decide on the proper method of carrying out disclosure. In this respect we differ considerably from the requirements of the Securities Exchange Commission in the United States where detailed instructions are provided as to the forms and methods to be followed in presenting financial information. On the other hand we have gone much further than the new United Kingdom Companies Act which with certain exceptions particularly as to consolidated statements merely calls for every balance sheet and profit and loss account to give a true and fair view. My own feeling is that we have achieved a good balance between the United Kingdom and United States viewpoints, probably typical of the halfway position Canadians tend to take on many other outside matters affecting the three countries.

I am sure that most of our profession would agree that where financial disclosure is concerned, it is highly desirable that as far as possible there should be uniformity between the Companies Acts of all the Provinces and the Government of Canada. Alberta has already acted. In closing, therefore, I would like to recommend, if you agree with the recommendations in the report, that your Institutes should modify them to meet the particular requirements for your Provinces and present them as your own to the appropriate provincial authorities.

How Not to Answer Examination Questions

By "Browndorf"
A Wellington solicitor and former lecturer in Commercial Law at the University of New Zealand

A few of the tribulations of examiners with examples of some of the terminological inexactitudes perpetrated by recent years' examination candidates

SINCE I have been an examiner for two years in a subject taken by second-year accounting students, and now that my mantle passes to a member of the staff of another constituent college of the University of New Zealand, I can freely give advice to accountancy students, especially on examination practice.

When the question asks for the meaning and effect of a certain statement of law which is quoted, and the candidate paraphrases the quoted statement without giving any additional matter of value, he wastes his time and gains no marks. It is amazing to read the matter, irrelevant and extraneous to a question, over which students waste their time and effort, and, where they are ill-prepared, the padding that can only reduce their marks. Answers should not be embellished with verbose explanations which kill their effect completely. Having stated the first answer on the law, the candidate should examine closely any matter he is tempted to add after that dangerous word "or". The instruction from the examiner at the top of the paper — "Answers should be to the point" — should be strictly followed.

The periods determined by a statute within which certain things must be done, or after which certain transactions are void, or determining the validity of resolutions, must be stated accurately. Errors of time limits and half-definitions put the examiner into the dilemma of whether to mark the whole question as worthless, or on the basis of *quantum meruit* (i.e., giving some credit for a partly correct answer). Probably the former method is more correct, especially as other candidates do give signs of proper and careful study.

Many students learn sections of the Act and quote them by number "parrot fashion". This is not a proper answer without a statement of what the section quoted by number refers to.

Other students give more than the question asks for. For example, the question "What do you understand by 'available act of bankruptcy?' " does not call for a detailed statement of the 11 Acts of bankruptcy, but a brief statement of their purpose only, in relation to a petition by a creditor. It is mistakes of this nature that lead candidates to say that the paper was too long.

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Some candidates do not keep themselves apprised of recent law. For example, the Joint Family Homes Act was passed in 1950, and properly prepared students should have been able to give details of the protection from debts allowed under the Act, as well as the limitations provided on the valuation of property, the amount of protection, and the use to which the property is put.

The following are examples of by no means exceptional answers which illustrate the foregoing comments:

Available Act of bankruptcy means the Act which is in force at any given time. At present the Bankruptcy Act 1908 is the available Act of bankruptcy.

The defaulting debtor is a menace to society and should be extinguished.

Bankruptcy: The word originates from the Latin *rupto,* to break (I break), and the meaning suggests the breaking of the bank.

Covenants to settle are void if they are for the purpose of preventing marriage.

Briefly a *defeasance* is something what defeats something else.

Bankruptcy is a question of law and insolvency is a question.

A man is *insolvent* when his assets exceed his liabilities and is thus unable to pay his creditors 20/-in the £1.

A family can now be protected from inclusion in an estate.

Under section 37 the acceptance [under the Sale of Goods Act] is full acceptance under the terms of the contract and usually takes the form of some act such as eating a poisoned chocolate . . .

It would be against the public for a man to be put permanently out of circulation.

Official Assignee has rights to disclaim onerous conditions such as cutting of lawns, digging drains, etc.

Administration of deceased's insolvent estate is under Part IV of the Administration Act because no penalties can in any case be made on the insolvent dead; against him there is no recourse.

Therefore during that three months it could be said that he is in "incubation" (presumably a possible bad egg).

If the arbitrator while one side was giving its evidence, was reading a thriller or otherwise not giving full attention.

If the arbitrator accepted bribes or acted in any way to promote his own interests there would be a ground for a charge of misconduct.

The 51st Annual Meeting of The Canadian Institute

By C. L. King, F.C.A.
Executive Secretary, C.I.C.A.

The executive secretary's report to the members of the C.I.C.A.

FOR the 51st time since becoming an incorporated body, members of the Canadian Institute of Chartered Accountants gathered together to discuss matters of national interest amongst the profession and renew acquaintances of former years. Victoria, capital city of British Columbia, was chosen this year for the first time as the site of the convention. Perfect weather and a perfect setting were enhanced by the truly wonderful hospitality shown delegates by their hosts, the British Columbia Institute of Chartered Accountants.

Members of the Executive and the Committee on Education and Examinations arrived in the city on Friday, September 4 and early on Saturday, September 5. By 9:30 a.m. both groups were in session and continued their meetings throughout the day. The Committee on Education and Examinations met again for an all-day session on Monday, September 7, while Council meetings were held on that day and throughout Tuesday, September 8.

This year three subjects were discussed at the technical sessions. Professor E. D. MacPhee, director of the School of Commerce, University of British Columbia, spoke on "Audit of Management Methods and Systems". Mr. T. A. M. Hutchison of Peat, Marwick, Mitchell & Co., Toronto, spoke on the recommendations of the special committee for amendments to the Companies Act, 1934, Canada and Mr. George G. Richardson of Clarkson, Gordon & Co., Toronto, spoke on "Depreciation and Capital Cost Allowances". It was clear from the large attendance at each session that the subjects discussed were of considerable interest and contributed to the increasing study of these problems in Canada. In addition, the B.C. Institute had arranged with the Aluminum Company of Canada to present their colour film "Prelude to Kitimat". This film provided a vivid description of this project as well as of the potentialities of the Province of British Columbia. The annual general meeting itself took place on Thursday morning, September 10.

Luncheon and dinner addresses were brief and numbered only two. At the B.C. Institute luncheon for members and their ladies held in the ballroom of the Empress Hotel on Wednesday, September 9, the guest speaker was

Mr. Einar Gunderson, C.A., British Columbia's Minister of Finance. He dealt with conditions and prospects in British Columbia, stating that only an increased population was necessary to ensure a bright future for the Province. Another highlight of this occasion was the presentation by Mr. J. M. Moynes of Calgary, chairman of the Board of Examiners-in-Chief, of a certificate to gold medallist, Edward W. Netten of St. Lambert, Quebec, who obtained the highest marks in last year's final examinations.

The closing dinner, which was preceded by the visiting Institutes' reception, was honoured by the presence of Sir Ian F. Bolton, vice-president of the Institute of Chartered Accountants of Scotland and Mr. Thornton G. Douglas, vice-president of the American Institute of Accountants. Also at the head table with their wives were Rear Admiral J. C. Hibbard, D.S.C., C.D., R.C.N., Constructor Captain C. V. Green, V.R.D., R.C.N., Commander R. J. Pickford, C.D., R.C.N. and Lieutenant Commander D. R. Saxon, D.S.C., C.D., R.C.N. Speech-making was kept to a minimum. Mr. Douglas brought good wishes from the American Institute, and Sir Ian Bolton, whose Scottish Institute celebrates its centennial in June of next year, spoke in the lighter vein and classed chartered accountants as, next to whisky, Scotland's best export.

Retiring president, Lorn McLean, was presented with a gold watch and chain by the Institute's new president, Walter J. Macdonald, who cited Mr. McLean's great contribution to the advancement of the profession. Mr. J. Grant Glassco also spoke briefly on Mr. McLean's services during the past year. At this dinner trophies for the annual golf tournament were awarded, the Richardson trophy going to the B.C. Institute for the low team score and the Thompson trophy to Mr. S. B. Laing of Alberta for the low net. Mrs. Lorn McLean and Mrs. Walter Macdonald were presented with beautiful bouquets by Mr. Pat Dunn, president of the B.C. Institute.

A most enjoyable and unusual feature of the social program arranged by the B.C. Institute was a three-hour sea cruise on *HMCS Ontario* and *Sioux* through the courtesy of the Royal Canadian Navy. The ship's officers escorted guests on tours of the cruisers, and by the time the afternoon was over, many a former "landlubber" felt quite at home amid the gun turrets, although some showed a decided preference for the wardroom.

The Crystal Garden provided an original and attractive setting for the B.C. Institute's reception and buffet supper on Tuesday, September 8 to almost 500 guests. After enjoying a water ballet performed by a group of attractive young women of Victoria and a most finished diving exhibition, many of the guests danced overlooking the green waters of the largest, heated, indoor, salt-water swimming pool in North America.

The ladies attending the meeting found that a full and very pleasant program of entertainment had been arranged for them. A popular meeting place each day was the suite where morning coffee was provided and the air was alive with a distinctly feminine brand of conversation which we venture to suggest had nothing to do with taxation, company law, or management systems. These functions, together with those attended by members with their ladies, contributed immeasurably to the success and enjoyment of this year's annual meeting.

Recent Books

Credits and Collections in Canada — New and Revised, sponsored by the Canadian Credit Institute, Credit Granters' Association of Canada, The Canadian Credit Men's Trust Association Limited and Associated Credit Bureaus of Canada; published by the Ryerson Press, Toronto, June 1953; pp. 414; price $5.50

The public accountant usually encounters credit management only when checking the reserve for bad and doubtful accounts. The accountant in industry and business is frequently concerned about credit management and as the management accountant often has to take a leading part in determining credit policy in his organization. The recent change from a sellers' to a buyers' market has revived the importance of the credit and collection problems as the weaker accounts become increasingly more interesting as additional outlets for fast accumulating inventories and surplus production. The publication of a standard text book in the credit management field in Canada is therefore very timely and will certainly be welcomed by accountants to whose responsibility the granting and control of credit belongs.

The reviewed book is a complete revision of the first publication in September 1947, which was out of print for several years. It is the product of the educational program of the Canadian Credit Institute as emphasized in the foreword written by J. R. Gilley, Director of University Extension, University of Toronto. Although the publication is used as a textbook in the credit course, its importance would be under-rated by considering it a book for students only. It is now established as the standard work on all problems facing the credit manager in Canada.

Those who have used the first edition will agree that the 1953 volume is an improvement over the first creditable attempt and contains, as the preface says, only 14 out of 59 chapters which have not been changed from the original text. A foreword written by K. G. Slocomb, C.A., stresses the tremendous expansion of the national economy in every direction, and the educational achievements of the various credit organizations among the buying public through publicity campaigns and other advertising media.

The volume is divided into four parts of which the first one deals with the general aspects of credit applicable to wholesale and retail in common. Part Two is devoted to wholesale, Part Three to retail, and Part Four to commercial legislation.

As each chapter is written by a different author, the level of presentation is not uniform, but good editing has succeeded in avoiding too much overlapping or repetition.

The coverage is fairly comprehensive although the reviewer was unable to find e.g. the Companies' Creditors Arrangement Act in the index or in the text — a remark which should not be taken as anything else but constructive criticism. Arrangements under this Act (Statutes of Canada 1933, ch. 36) are made in current practice.

The reviewer is satisfied that the new issue should be within reaching distance for every credit manager, but the book will also prove valuable for vice-presidents in charge of finance, treasurers, comptrollers and chief accountants as well.

GEORGE MOLLER, D.jur., C.A., R.I.A.
Hamilton, Ontario

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C P A Handbook, Volume 2; published by American Institute of Accountants, New York. Volume 1 and 2, pp. 1750 approx. and supplement pp. 170; price $27 U.S.

Duties of Junior and Senior Accountants, supplement to CPA Handbook; also available separately, price $3 U.S.

Volume 2 and the supplementary volume *Duties of Junior and Senior Accountants* are now available. Volume 1, reviewed in the May issue, contains 13 chapters which deal with professional ethics, legal responsibility, office organization, staff selection and training, fees and professional standards.

The second volume is bound similarly to Volume 1 with each of the chapters comprising a separate booklet, thus making it possible to obtain extra copies of particular chapters. This volume deals with the activities of a public accountant such as audit working papers, reliance upon internal control, report writing, tax practice, and special investigations. The numerous appendices provide examples of forms and procedures in actual use by accounting firms, such as a checklist of audit procedures, internal control questionnaires, rules for form and terminology in financial statements and extracts from report manuals.

The handbook is outstanding in two respects. Its 27 chapters bring together more information on the management of public accounting practices and on auditing procedures than has been previously available in one place. Also, its 27 authors appear to be outstanding members of the profession and each has specialized in one chapter of the project.

This is essentially a handbook or book of reference and not a text that one would read chapter after chapter. However, the chapter "Accounting Principles and Their Application" is an interesting consideration of basic principles of accounting. It states that in the opinion of accountants generally, accounting principles are not principles of nature but rules of human behaviour to be developed by man. They are, therefore, not immutable and they need to be changed to meet changing needs. They are designed for the greatest usefulness of those who need to rely upon accounting. For example, the generally accepted principle for pricing inventory and determining the cost of goods sold was for many years the specific cost of each item or an assumed equivalent, the first-in first-out method, with only casual recognition of a few seldom-used procedures such as average cost; yet in recent years the last-in first-out method, seldom heard of until after 1930, has come to be generally accepted as an alternative.

A separately bound volume *Duties of Junior and Senior Accountants* contains the last two sections of the handbook. A student will find here not only the types of work which he may be expected to perform but explanations as to why the task is necessary and what is the best procedure to use. This should be useful reading for him shortly after his service begins. As he is assigned new tasks, reference to the subjects in this volume will assist him in approaching the work with confidence based on an understanding of why and how he is to perform the work.

ALBERT C. JOHNSTON, C.A.
Toronto, Ontario.

Letters from Readers

Montreal, Sept. 11, 1953

PENSION PLANS FOR THE SELF-EMPLOYED

Sir: I am glad to note from your editorial in the June issue that Mr. Abbott's invitation to the professions to study the question of pension plans for the self-employed will assuredly be accepted. I personally wrote to Mr. Abbott on this subject on March 7, 1952 as follows:

> "I note that the Chamber of Commerce is suggesting that some machinery should be set up whereby individuals not covered by a recognized pension plan should be enabled to make personal provision for pensions under proper safeguards. Some years ago I made a similar suggestion to you and was informed that it was impracticable although it did not then and still does not seem to be beyond the ingenuity of your officials to devise some plan towards this end. The present situation is that a large segment of the individual taxpayers is subsidizing pensions to the rest of the population."

I read in Hansard with interest the exchanges between Mr. Abbott on the one hand and Messrs. Fleming and Fulton on the other, and subsequently wrote Mr. Fleming congratulating him and his colleague on their very able rebuttal of Mr. Abbott's objections.

It is, I think, unfortunate that the impression has been created that relief is being sought only for the "self-employed" *professional* man. The employee who is not fortunate enough to be connected with a company having a pension plan and, indeed, any taxpayer not in that position, is in precisely the same situation. Mr. Abbott himself brings out this point.

Mr. Abbott's explanation of how it comes about that employees are given a deduction for their contributions to approved pension plans, while historically interesting, is rather irrelevant. The fact is that they do get such a deduction, and Mr Fleming effectively disposed of the argument that employees do not "receive" the amounts which go into the funds for their benefit.

The committee appointed to deal with this matter will no doubt deal vigorously with Mr Abbott's statement that "their (the professional group's) income is not now taxed twice", his example of the "very reasonable tax treatment" accorded purchasers of endowment policies or annuity contracts as regards interest, and his remark that "the discrimination against the self-saver is not as great as it might appear to be on the surface", (all of which ignores the differences between the effective *rates* of taxation during the pre- and post-retirement periods). Mr Fulton adequately outlined possible restrictions to allay the Minister's fear of the self-employed person securing the tax saving by "merely changing the form of his assets", and it might be necessary to concede that no allowance be given in respect of "past services".

Any scheme would require to ensure that the self-saver did not always have his assets available to him "for emergency or for convenience". Either amounts set aside could be frozen, as in the case of government annuities, or insurance companies could be obliged to report annually any taxable payments to beneficiaries under pension or annuity contracts, which, with government annuities, would probably be the most effective media for granting relief to taxpayers who require to make their own provision for retirement income.

J. WILSON CRAIG, C.A.

Vancouver, B.C., Sept. 24, 1953

ARE BAD DEBTS AN EXPENSE?

Sir: In the June issue of *The Canadian Chartered Accountant* appears a letter dated April 7, 1953 from Mr. J. E. Smyth, C.A., of Queen's University, concerning the term "allowance for doubtful accounts".

I suggest that in the profit and loss account the charge be described merely as "bad debts" instead of "bad debts expense", as suggested by Mr. Smyth. The item is not one of an expense incurred, but is a loss sustained. The term "bad debts" is fully explanatory.

As to the balance sheet, the deduction for anticipated or estimated loss on realization of the accounts receivable, I think, should be expressed as "allowance for bad debts" not "allowance for doubtful accounts". Such losses are generally known as "bad debts".

W. G. ROWE, F.C.A.

Noranda, Que., Sept. 21, 1953

ON PURISM

Sir: Comment and Opinion in *The Canadian Chartered Accountant* is always a first choice reading on the day of arrival here and after a careful study of the technical articles which follow it is now quite entertaining to finish with Sweetness and Light.

It seems that chartered accountants have a hobby in etymology. This has a serious and less important side: if we fail to preserve an authoritative syntax our language and speech will deteriorate, both as to arrangement and articulation; if it is taken too seriously a balance may be lost to pedantry. The editor was not wrong in November; a purist is one who aims at purity, hence there can be a better purist (with a better aim). Mainly, there is the danger of endeavouring to be logical and correct in a language which has been unable to withstand the onslaught of established usage.

Many forms of writing are replete with errors, which have become accepted only by common usage. "Jeopardy" is entirely phonetic script from the French "jeu parti", meaning even-play or 50/50 chance, probably now 30/70. "Less" is a comparison of two, yet the Income Tax Act and forms use "lesser". The "fullest extent" only indicates emphasis as there is no comparison of full. "Human Race" is rarely seen in its correct form, the plural (e.g. the Caucasian race is the whitest of the human races). Even Dickens chose "Our Mutual Friend", which should have been "Common Friend". The double possessive has long broken the sound barrier (e.g. a friend of Brown's). It is only the pressure of print and sound that has forced adoption of a *Federal Government* in Canada. "Federal" means pertaining to a league or treaty and was adopted in the U.S.A. after the civil war. Ottawa has never officially approved the nomenclature "Federal" for the Canadian Government.

Even the carefully prepared certificate of the chartered accountant (or Dominion Companies' Act) is defective. He obtains *all* the information he has required but certifies only on the *best* of his information. *All* would be expected to include the best and the worst so why not say only *the* information? The reason is it has become just another colloquialism.

Language too has its rhythm — the caption of your column sounds a dischord. Sweetness and Lightness would be in balance, Sweet and Light more euphonic, Sweet and Bright (over Jay Vee) more appropriate, but for this column in your publication may I suggest rather HEAT, LIGHT AND POWER.

L. A. ROBERTON

High River, Alta., Sept. 22, 1953

YEAST FOR HEAVY BREAD

Sir: Your column "Sweetness and Light", supplies the yeast for the heavy bread of *The Canadian Chartered Accountant* magazine. Your comments on the tendency of British Columbia brethren to use "pure" English are piquant, to put it mildly.

The opening sentence of the article entitled "Property Transactions between a Company and a Shareholder", appearing on page 102 of your September issue, could never have been written by a British Columbian. It reads, "In two recent cases in the Income Tax Appeal Board . . . . " It is impossible

for two cases to be in any Income Tax Appeal Board unless they were cases of liquor, which heaven forbid! It is possible that the writer meant his readers to infer this?

ALBERTAN

Toronto, Ont., Aug. 25, 1953

A PROBLEM SOLVED

Sir: In the June, 1953 issue of *The Canadian Chartered Accountant* the following problem appeared in the "Sweetness and Light" column:

> "Find the effective rate of interest on an actual loan of $93,000 to be repaid by 12 monthly instalments of $8,333 at the end of each month, the first payment of $8,333 being one month hence."

Reader McBain (and others) may be interested in the following solution:

SOLUTION

We will begin first with the development of an actuarial formula which will prove helpful later on. Let us assume the following symbols—

1. Let "i" be the rate of interest over one period.
2. Let "v" be the present value of "1", one period hence.

We then see that $v = \dfrac{1}{1+i}$

3. Let $a_{\overline{n}|}$ be the present value of an annuity of "n" payments of "1", the first payment being 1 period hence, the second payment two periods hence and the last payment "n" periods hence.

Now then, a loan of "1" now for "n" periods at the interest rate "i" can be repaid by "n" payments of "i", and the "1" at the end of the "n" periods. We can represent this by the following equation:

$$1 = i \times a_{\overline{n}|} + v^n$$

i.e.

$$a_{\overline{n}|} = \frac{1 - v^n}{i}$$

In our problem we have the following —

$$93{,}000 = 8333\ a_{\overline{12}|}$$

$$\therefore a_{\overline{12}|} = \frac{93{,}000}{8333} = 11.1604$$

If we use our formula above and a trusty logarithm table, we find (omitting mechanical details) —

$$a_{\overline{12}|} \text{ at an interest rate of } 1\% = 11.25508$$

$$a_{\overline{12}|} \text{ at an interest rate of } 1\tfrac{1}{4}\% = 11.07931$$

Then, by simple linear interpolation we arrive at an approximation—

That $a_{\overline{12}|}$ at an interest rate of $1.134\% = 11.1604$

To satisfy ourselves that this interest rate is correct, we can prove it by the preparation of an amortization table as follows:

Period (in months)	1. Principal at beginning of Period	2. Combined Payment of Princ. & Int. $8,333.00	3. Interest Portion Paid i.e. 1.134% of Principal at begin. of Period	4. Princ. Portion Paid $8,333 less Interest Portion 2 — 3	5. Principal at end of Period 1 — 4
1	$93,000.00	$ 8,333.00	$ 1,054.62	$ 7,278.38	$85,721.62
2	85,721.62	8,333.00	972.08	7,360.92	78,360.70
3	78,360.70	8,333.00	888.61	7,444.39	70,916.31
4	70,916.31	8,333.00	804.19	7,528.81	63,387.50
5	63,387.50	8,333.00	718.81	7,614.19	55,773.31
6	55,773.31	8,333.00	632.47	7,700.53	48,072.78
7	48,072.78	8,333.00	545.15	7,787.85	40,284.93
8	40,284.93	8,333.00	456.83	7,876.17	32,408.76
9	32,408.76	8,333.00	367.52	7,965.48	24,443.28
10	24,443.28	8,333.00	277.19	8,055.81	16,387.47
11	16,387.47	8,333.00	185.83	8,147.17	8,240.30
12	8,240.30	8,333.00	92.70	8,240.30	—
		99,996.00	6,996.00	93,000.00	

(I took the liberty of adjusting the last interest payment by 75c to $92.70 so that the balance at the end would be nil.)

Thus we see that the monthly rate of interest is 1.134%. Accordingly, the annual effective rate of interest is $(1.01134)^{12}$ less 1, and by the use of our logarithm tables the interest works out to be 14.47% per annum.

It does appear strange that the course of instruction for students of the C.A. course does not place more emphasis on mathematics of investment. The writer can recall only two instances of any reference to investment mathematics in his course of instruction, viz — annuity and sinking fund methods for depreciation, and sinking fund accounting.

The writer feels that an elementary course in investment mathematics should form part of the basic training for accounting students.

MORRIS H. STARKMAN, B.COM., C.A.

Professional Notes

ALBERTA

Mr Leslie J. Munn, F.C.A. was awarded a Fellowship at the annual meeting of the Alberta Institute on June 19.

BRITISH COLUMBIA

Frederick Field & Co., Chartered Accountants, Royal Bank Bldg., Vancouver, announce the admission to partnership of Mr Neil G. Russell, C.A.

MANITOBA

Dunwoody, Saul, Smith & Co., Chartered Accountants, announce the removal of their offices to 2nd Flr., 100 Princess St., Winnipeg.

QUEBEC

Messrs Karl Rudick, C.A. and Morton A. Katz, C.A. announce the formation of a partnership for the practice of their profession under the firm name of Rudick, Katz & Co., Chartered Accountants, with offices at Rm. 304, 477 St. Francois Xavier St., Montreal.

* * *

Messrs Paul-E. Dugre, C.A. and Lionel Janna, C.A. announce the opening of an office for the practice of their profession at Rm. 201, Salem Janna Bldg., Shawinigan Falls.

News of Our Members

Mr John G. McWade, C.A. (Ont.), has been appointed controller of the Standard Paint and Varnish Co. Ltd., Windsor.

* * *

Mr A. Dudley Ward, C.A. (Ont.), has been appointed executive secretary of the Board of Social and Economic Relations of the Methodist Church in the United States, with headquarters in Chicago. He has directed the studies for a series of seven volumes entitled "Ethics and Economics of Society" and has himself written two of these volumes, "Goals of Economic Life" and "American Economy in the Lives of People". The series is being published by Harpers Brothers this fall.

Several chartered accountants, active in the Institute of Internal Auditors, Toronto Chapter, are among the lecturers for the Eighth Annual Fall Training Course sponsored by that Institute and managed by the University of Toronto. On October 13 Mr L. F. Stevens, C.A. (Ont.), spoke on "Cooperation of the Internal and External Auditors". At the next meeting Mr J. A. Cooper, C.A. (Ont.), dealt with "Finished Goods, Sales and Receivables". He was followed by Mr Edward Paterson, C.A. (Ont.), who spoke on "Cash Receipts and Disbursements".

Lined up for papers in November are Mr J. W. M. Dixon, C.A. (Ont.), whose specialty is "Payrolls and Services", Mr G. H.

Ward, C.A. (Ont.), who will speak on "Case Studies in Fraud and the Control of Assets" on November 10, Mr W. Tyler on "Purchasing and Material Control" on November 17, and Mr A. E. Green, C.A. (Ont.), who will talk on "Fixed Assets and Scrap" on November 24.

On December 1 Mr F. W .Woods, C.A. (Ont.), will discuss "Manufacturing Operations and Costs", and Mr C. R. Jolly, C.A. (Ont.), will close the course on December 8 with a paper on "Company Records".

Obituary

Colonel Robert H. Montgomery

Although he was not a member of any of the Institutes of Chartered Accountants in Canada, Col. Robert H. Montgomery who died last May was such an outstanding figure in the accounting profession that it is fitting to pay tribute to him in the columns of this journal.

Most people will associate him as author of the text *Auditing Theory and Practice* which he first brought out in 1912 and which was later republished in several revised editions. He also wrote *Income Tax Procedure* and *Federal Taxes on Estates and Gifts*, both classics in their respective fields.

Col. Montgomery was born in Mahony City, Pa., the son of a minister of the Methodist Episcopal Church, and in 1889 joined the firm of John Heins, a leading public acaccountant of the time. Admitted to partnership in 1896 in the firm of Heins, Whelan, Lybrand & Co., he devoted himself to the organization of the accounting profession. He was a charter member of the Pennsylvania Association of Public Accountants, and laboured for many years in various early national federations of accountants which preceded the American Institute. It was during his presidency from 1935 to 1937 that the American Institute emerged as the one national organization of all American certified public accountants.

Teacher as well as practitioner, he lectured in the evening classes conducted by the Pennsylvania Association of Public Accountants in 1902. Later he lectured at New York University and at Columbia. In 1919 he was made a Professor of Accounting at Columbia.

Together with the late George Wilkinson he promoted the first International Congress of Accountants which took place in St. Louis in 1904, and attended the subsequent congresses regularly.

In addition to his career as a professional accountant, Col. Montgomery studied law and was admitted to the Bar in Philadelphia in 1900.

It is undoubtedly true that there is scarcely a student or practitioner of accounting in the United States and Canada today who is not indebted in some way to the contribution which Robert H. Montgomery made to his chosen profession.

Accounting Research

By Gertrude Mulcahy, B.A., C.A.
The C.I.C.A. Research Department

THE AUDITOR'S REPORT

IT HAS been said that although the auditor's main concern is auditing, he must also be a master of expression. Since the shareholders will not have the opportunity of evaluating, through personal enquiry, his ability as an auditor, they will be more likely to form a judgment on the basis of the wording of his report to them. The repeated appearance in accounting publications of articles dealing with the form and content of the auditor's report, techniques of writing audit comments, the problems and terminology of reports of accountants and related matters, indicates that the prime importance of this subject is recognized.

In recommending a standard wording for the auditor's report, the Committee on Accounting and Auditing Research has helped to alleviate the difficulties and problems faced by the auditors of limited companies who are in a position to express an unqualified opinion on the financial statements of a concern. However, where the auditor must include specific qualifications to his opinion, or where he is reporting on the financial statements of a sole proprietorship or partnership, etc., he is dependent on his own ability to express in clear concise language the ideas that he wishes to convey. Naturally this is an extremely difficult task because it involves the stating of technical matters in a form understandable to readers who have no accounting background.

Clarity of Reports

In the analysis of the auditor's report included in the 1949, 1950 and 1951 financial statements examined, particular attention was paid to the clarity of wording and presentation.

Although it may be considered as relatively insignificant, it is important that the auditor's report be designated as such and be addressed to the client — namely the shareholders.

Figure 1 sets out the breakdown of the terminology used in the 1951 financial

Figure 1
TITLE OF AUDITOR'S REPORT

1951	Terminology
73%	Auditors Report
5%	Auditors Certificate
2%	Sundry
20%	No title

Figure 2

ADDRESSEE OF AUDITOR'S REPORT

1951	Addressee
91%	Shareholders
2%	Sundry
7%	No addressee

reports for the title to the auditor's report. The sundry terminology includes such titles as auditor's statement, certificate etc.

Figure 2, which sets out the detailed breakdown of the addressees of accountant's reports for 1951, shows that in most instances the auditors address their reports to the parties to whom they are to report. The sundry category includes directors, company, members of the company, etc.

Qualifications of Auditors' Opinions

Of the auditor's reports accompanying the 279 financial statements for 1951, approximately 86% expressed an unqualified opinion as to the "true and correct view" of the financial statements although 15% of the reports included information designed to explain the basis upon which the auditor had formed his opinion. Qualifications to the auditor's opinion were included in 8% of the reports, but a number of these were in respect of items that could not be regarded as of major importance. Furthermore, 6% of the auditor's reports were so worded that it was impossible to determine whether the details given were intended to be a qualification of opinion or merely an explanation of the basis on which the auditor formed his opinion.

"To qualify" is defined as follows: "to reduce from a general, undefined or comprehensive form to a particular or restricted form". In other words, in qualifying his opinion the auditor places a specific restriction on his expression of opinion. The necessity for such limitation may arise from changes in or deviations from consistent application of accounting principles, existence of uncertainties, weakness in the company accounting procedures, or factors affecting the scope of the auditor's examination. Mr. E. J. Taylor, C.P.A., a member of the American Institute of Accountants, says, "Exceptions should be stated so that their import may not be susceptible of misunderstanding, and with careful regard for the relative importance of the exception to the statement as a whole."

Generally the qualifications included in the auditor's reports analyzed for 1949, 1950, and 1951 covered such matters as: changes in accounting basis, basis of determination of value of inventories, adequacy of accumulated depreciation and current provision for depreciation, uncertainty of actual validity of specific items in the financial statements, inadequacies of specific accounting procedures, and limitations of examinations.

Examples of Qualifications of Auditors' Opinions

Example 1

" . . . . Included in the current liabilities are provisions and reserves which in our opinion are, in the aggregate, some $2,750,000 in excess of actual liabilities.

"Subject to the foregoing, we report that in our opinion the accompanying . . . ."

In the above extract the auditor sets out clearly that he is not in agreement with the policy adopted by the company in respect of its estimates of current liabilities. Compared with the total current liabilities of some $44,000,000, as set out in the balance sheet, the dollar value of the over-provision would seem to be relatively insignificant. However, when we look at the individual items making up this total, the inclusion of the auditor's qualification becomes quite understandable since the auditor's remarks may be assumed to refer to the accounts payable, accrued charges, and provision for taxes, which in this case total approximately $19,000,000.

* * * * *

Example 2

" . . . . The carrying value of the investment in securities of subsidiary companies has been changed during the year ended December 31, 1951 from the basis of cost or lower to a basis reflecting such investment at the book value of the company's equity in the net worth of each subsidiary as of the close of the year. In accordance with Section 114 of the Companies Act (Canada) we report that the dividends received from subsidiaries during the year ended December 31, 1951 have been included in income for the year and the net undistributed earnings of subsidiaries for the year ended December 31, 1951 have been reflected as an addition to earned surplus. In determining such net worth and earnings of each subsidiary unrealized inter-company inventory profits have been eliminated.

"The depreciation on fixed assets provided for the year ended December 31, 1951 is approximately $950,000 more than the amount which would have been provided on the basis used for the year ended December 31, 1950, resulting in a decrease of $450,000 in 'Net income for the year' after providing for taxes on income.

"We report that, in our opinion . . . . "

In the above example the auditor not only sets out clearly and concisely significant changes in the basis of accounting from that of the preceding year, but also the impact of such changes in the current financial statements. There is no doubt left in the mind of all readers, even those uneducated in the techniques of accounting, as to the information that the auditor wishes to convey. Since the dollar value of the addition to earned surplus resulting from the change in basis of accounting for investment in securities of subsidiary companies was shown as a separate item in the statement of earned surplus, its inclusion in the auditor's report was not necessary to a full understanding of the impact of the change in accounting basis. Since the auditor's opinion is not stated to be "subject" to any qualification it is normally presumed that it is an unqualified opinion. Presumably the auditor's remarks are to be regarded as explanatory since the amounts involved can be regarded as not material in relation to the reported net profit.

* * * * *

Example 3

" . . . . Having regard to the valuation of fixed assets determined by the directors on the 29th of January, 1951, it is our opinion that, although the provision for depreciation in the sum of $15,617.26 is the maximum allowed by the Department of National Revenue for Canadian income tax purposes, nevertheless it is lower than the amount should be in applying depreciation rates generally applicable to these fixed asset values.

"Subject to the foregoing, we report that, in our opinion . . . . "

The auditor, in this case, indicates doubt as to the validity of the basis followed by the company in the calculation of the current provision for depreciation. Since the auditor has seen fit to qualify his report as a result of such an under-provision, it would be fair to assume that the amount involved must be significant in relation to the results of the current operations. Would it not be better if the auditor, instead of giving only the clue, set out the approximate amount of such under-provision in order that his qualification may have provided more specific information as to the overstatement of earnings for the year in the financial statements?

* * * * *

Example 4

" . . . . Our examination included tests of the head office and . . . . branch accounting records and we have been furnished with returns from the other branches, certified by the managers.

"The inventories of stocks on hand at December 31, 1951 have been certified by the management and provision has been made for losses on outstanding accounts receivable considered bad or doubtful. The cash and bank balances at the other branches were reconciled with certificates received from the company's bankers. So far as we were able to determine all liabilities of the company at December 31, 1951, have been taken up on the books as of that date and are reflected in the attached accounts.

"On this basis, we report that, in our opinion . . . . according to the best of our information and the explanations given to us and as shown by the books and certified branch returns of the company."

It is difficult to determine the reason for the inclusion of the above in the auditor's report. On reading such a report one might well ask, "is the auditor qualifying his opinion?", or "is he merely including in his report explanatory remarks which he feels will make the financial statements more understandable?" Whatever was the intention, the result is confusing.

In the first sentence, the auditor sets out, in general terms, the procedures followed by him but, having said that he has been furnished with the returns from other branch offices, he fails to set out his reason for mentioning this fact. If these returns were of such significance as to warrant mention of their receipt, then surely the auditor should state clearly the basis on which such returns were accepted and included in the financial statements. The statements as to the certification of the inventory and provision for losses on outstanding trade accounts are, presumably, merely clarification of descriptions which are not included in the balance sheet, but which the auditor feels should be made known to the reader. On the other hand, perhaps the reference to the inventory could be taken as an indication that the auditor merely accepted this figure without further enquiry.

The readers, particularly those with

any accounting training, become more confused in reading the reference to the procedures relating to the cash and bank balance. It is assumed that any auditor would automatically satisfy himself as to the cash and bank balances. While there could be some justification for specific comment if the assets of the company were made up almost entirely of cash and bank balances, in this case, the cash and bank balances make up only 3% of the total assets of the company.

The words "so far as we were able to determine" are not definite and leave the reader doubting if the auditor is sure of his grounds.

"On this basis"; are these words intended to signify a qualification of opinion, or are they intended to signify that the opinion has been arrived at on the strength of what has been set out in the previous paragraph? That is a question that only the auditor can answer.

* * * * *

Example 5

" . . . . With reference to the five subsidiary companies, the accounts of which were not examined by us, we inspected the balance sheets thereof as at March 31, 1951, together with the related statements of profit and loss and earned surplus, and the reports thereof of the chartered accountants who are the appointed auditors of the companies. The net assets and the combined earnings of these five companies represent respectively a substantial proportion of the consolidated net assets and of the consolidated income for the year.

"In our opinion . . . . according to the best of our information and the explanations given to us and as shown by the books of the companies which we examined and the audited accounts of the five subsidiary companies referred to above."

The auditor has included the above explanation to denote the extent to which he has relied on the work of others as the basis for his opinion.

Even with the reference to the substantial significance of the subsidiary companies, the lack of any wording such as "subject to" indicates that the auditor is prepared to accept the full responsibility for his expression of opinion.

Practitioners' Forum

Conducted by Geoffrey H. Ward, C.A.

FORMS OF TRIAL BALANCE USED IN AUDITING SMALL BUSINESS

MOST accountants have their own ideas as to the best form of trial balance for everyday use. To provide some ideas for discussion we present an actual copy of the instructions in use by a small firm, illustrated with a facsimile. This is followed by some panel members' comments.

Instructions to Staff

TRIAL BALANCE & ADJUSTING ENTRIES

Purpose

This memo outlines a procedure for recording general ledger trial balances and adjusting entries in the working papers. Using this method will ensure uniformity. This method has the advantages of compactness, clarity, and efficiency in use.

Trial Balance

Form

Columns—The trial balance should be taken off on eight-column paper. The eight columns are used for:

Account description (first three cols.)
General ledger balances
Adjustments — debit
Adjustments — credit
Adjusted balances
Statement figures

This form is sometimes called a "Spread Sheet". If the adjusting entries are few the column for the "Adjusted Balances" may be omitted.

Sheets — Separate sheets are used for (1) assets, (2) liabilities and (3) operating statement amounts. Included on the asset page are credit balances which appear on the asset side of the balance sheet, e.g. the allowance for bad debts and accumulated depreciation figures.

Sequence — The general ledger accounts will be listed on the spread sheet in the order of the balance sheet headings in which they belong regardless of the order in which they appear in the ledger. In this way the sub-total under each heading, after making the necessary adjustments, will be the amount shown on the balance sheet. Last year's grouping should be used as a guide to determine where each ledger account belongs. Of course, as far as practicable, the accounts should be arranged in the general ledger in the order required for statement purposes.

It is usually advisable to double-space the items on the spread sheet.

Statement Preparation

The completed trial balance will contain all the information required, except percentages, to write the letter to

Illustration of part of a page

SMITH PRINTING CO.

ASSETS

30 June 1953

Account	Dr.	Adjustments Dr.		Adjustments Cr.	Final Balance †	To B/S
Cash on hand and in banks						
Cash	$1,263.51		(1)	$ 400.00	$ 863.51	
Change funds	100.00				100.00	
Petty cash	100.00		(2)	82.00	18.00	
Royal Bank	4,281.60				4,281.60	
Bank of Montreal	125.00				125.00	
					———	$5,388.11
Accounts receivable						
Accounts receivable	25,622.50		(3)	712.90	24,909.60	
Deposits	425.00				425.00	
Payables—debit balances		1,464.40	(4)		1,464.40	
Advances	250.00				250.00	
					———	27,049.00
Allowance for bad debts	1,000.00*			500.00	1,500.00*	
					———	1,500.00*

† This column may be omitted as a short-cut as it is not needed unless the adjustments are numerous.

* These figures would appear in red to denote a credit balance on a sheet of debit balances.

the Board. The actual preparation of the financial statements will involve no calculation of figures. They can all be copied from the spread sheets. This allows the person preparing the statements to concentrate on the wording and presentation and so produce much better drafts than would be the case if he were also concerned with calculating the figures.

Review

This form of trial balance facilitates reviewing the statements, as it shows at a glance the items making up each statement item. Checking the statements with the trial balance can be done easily as all the figures on the statements are exactly as they appear on the spread sheet.

Final Check

As our report to the shareholders states that the statements are "as shown by the books", we must be certain that all adjusting entries (other than reclassifying entries) have gone through the client's books. Therefore the final adjusted trial balance should be checked off with the client's ledger.

Adjusting Entries

Correcting Entries

Adjusting entries which have to go through the client's books should be made directly in the client's journal or other book of original entry and posted to the general ledger. If practicable this should be done before our trial balance is taken off and so avoid duplication. For this reason it is wise to delay taking off the trial balance. Once our trial balance is taken off any other adjusting entries which have to go through the client's books will also have to be listed and posted to the spread sheet.

In cases where it is not practicable to make all the adjusting entries in the client's books in the first instance, they should be written out in duplicate and

copy given to the client. Then the client's bookkeeper can re-copy them into the books.

Entries for Statement Purposes

In addition to adjusting entries there may be some entries that do not have to go through the books, e.g. reclassification entries transferring debit balances from accounts payable to accounts receivable. These should be listed and posted to the spread sheet.

On interim statements there will be a lot of adjusting entries that should not be entered in the client's books.

Form

The adjusting entry sheets contain columns headed (1) Name of Accounts, (2) Debit and (3) Credit. Unless it is quite obvious what the entry is, an explanation should be given below the entry.

Adaptation for Larger Business

In another kind of trial balance, more suitable for large companies, the general ledger balances are spread throughout the working-paper file. For example, the cash balances are listed on one work sheet headed "Cash" and the total is carried forward to a summary sheet or directly to the balance sheet. Thus the summarizing and listing operation is done in one step. This individual sheet for each balance sheet item is useful in the case of large audits where there may be a dozen trial balance figures for each balance sheet item. One continuous trial balance would be very bulky. The breaking down of general ledger balances into various sections facilitates the work when one member of the staff works on cash, another on inventories, etc. Each staff member can have his own trial balance figures in front of him. In both these forms of trial balance the features of listing and summarizing in one step and compactness are present.

Assisting in the preparation of this column is a panel of chartered accountants who are in public practice in various Provinces of Canada. This month the help of N. V. Hagan, C.A., of Moose Jaw, Saskatchewan, and D. A. Ross, C.A., of Calgary, Alberta, is gratefully acknowledged.

Comments on the Above

A practising accountant has the following to say about the above:

"The procedure outlined is similar to the use of the spread sheet in this office for trial balance purposes. The experience in this office is that a considerable amount of analysis is usually required for statement purposes, so it is not always possible to prepare the financial statements from the trial balance without reference to working papers. Our procedure is to keep the working papers in trial balance order for easy reference. We use an 11-column spread sheet, which leaves room at the right for such uses as grouping of trial balance items for balance sheet purposes and analysis columns. The extra columns are also used at various times for post adjustments after the draft statement has been discussed with the client.

"Our policy with regard to closing and adjusting entries is to furnish the client with a typed copy of the entries, together with a reconciliation of surplus account to prove the books with the financial statement when all entries are made. We discourage a policy of making entries in the clients' records and wherever possible request that the adjusting and closing entries be written into the records by their own bookkeeper.

"With regard to the form of adjusting entries, I believe that full explanations should be written for every entry, since entries which might be obvious to

the staff member working on the audit may not be as readily understood by the clients' bookkeeper or audit staff for purposes of review or subsequent reference purposes.

"While there may be other forms of trial balances and working papers, it is the feeling in our office that on every assignment there should be a trial balance spread sheet backed up by working-paper files, properly cross-referenced, whether the audit be a small or a large one. There does not appear to be any particular advantage in a trial balance spread through the working paper file, because it has to be at some time summarized in extended form for statement purposes if any audit adjustments are necessary after the client has closed his books.

"A policy which is usually followed is to have junior staff prepare the working papers in advance of the audit, including taking off the trial balance and heading up working paper sheets. This can be done as a gap filler at a slack time of the year and minimizes the amount of paper work at audit time, which usually is at a busy time of the year."

Another Form in Use

In a form used by another firm, a split between balance sheet and income account items is made at the time of writing the trial balance and related journal entries. It is used in conjunction with balance sheet lead schedules and a profit and loss aggregation summary.

Advantages of this method are that when it is maintained on a progressive basis the net profit is shown as a part of the trial balance prior to taking off statements. It can at times facilitate allocation of items in preparing statements quickly.

LET US HEAR FROM YOU!

Readers are invited to contribute to this forum by sending in brief notes on practical problems of the public accountant, auditing procedures and their application, ideas and experiences which will be interesting and helpful to other accountants.

Our objective is to provide a place for members to discuss their practical problems, for our mutual benefit.

The Students' Department

J. E. Smyth, C.A., Editor

NOTES AND COMMENTS

Correspondence with the editor is cordially invited

Are Prepaid Expenses Current Assets?

IN the April 1953 issue of *The Journal of Business Education* Professor John N. Myer of the City College of New York raises this question for discussion. He writes, "Since the prepaid expenses will not become available to liquidate current liabilities in the normal course of events, should they be considered current assets?" In the conclusion of his article he expresses the view that "The inclusion of the so-called prepaid expenses among the current assets defeats the purpose of the *current asset* category."

From this view we respectfully dissent. We think that prepaid expenses are properly classified as current assets.

For us prepaid expenses, like merchandise inventory (and fixed assets too, for that matter) are costs incurred for the purpose of realizing revenue. They are of course only a part of the costs incurred in the past for that purpose. They are those costs which have not yet contributed to revenue but which in the ordinary course of business will do so. The question is merely *how soon* they will contribute to revenue.

What is often overlooked is that the typical business does not sell merely merchandise (as defined by the accountant) to its customers; it sells *services* as well. If one thinks of a retail business, for example, he is bound to admit that the economic justification for the retailer is not the merchandise itself — the merchandise was produced by some other business — but is rather the service rendered to customers by the retailer in making the merchandise more accessible to them. Another way of putting this proposition (and perhaps somewhat easier to follow) is that the services performed by the retailer give the merchandise an enhanced value. Unfortunately for our present purposes, however, the accounting definition of merchandise (i.e. the accounting method of calculating *cost* of merchandise) does not recognize this enhanced value.

Even the manufacturer himself must be said to sell services in addition to finished goods, if we define finished goods in the accounting sense of "inventory costs". Only manufacturing expenses are included in the cost of finished goods. The manufacturer's selling, administrative, and financial expenses are over and above that. Yet the manufacturer expects to clear *all* his costs in his sales revenue. He must therefore be thought of as in

fact selling both finished goods (represented by their manufacturing cost) *and* services (represented by the various selling, administrative, and financial costs).

If our argument is valid thus far, what then is the difference between merchandise inventory and prepaid expenses? Both are assets (in the form of costs) awaiting realization through sale to customers. If the test of a current asset is that it shall be, or become, available for the payment of current liabilities within the next year, then prepaid expenses, just as much as merchandise inventories, may meet this test: one, as much as the other, will be sold to customers and "realized" within the coming year. (Sometimes, if the amount is important, we may have to invent a special heading outside the current asset section for prepaid insurance covering a period of more than one year after the balance sheet date; but to say that the possibility of such an item is reason for always excluding all prepaid expenses from current assets is in our opinion very much like letting the tail wag the dog.)

* * * *

On the other hand if one were to argue that *neither* merchandise inventory *nor* prepaid expenses should be included in current assets, we would be more inclined to agree. To include any unexpired cost in current assets is to assume that sales can be made within the term of the current liabilities sufficient to reimburse the unexpired cost. The realization of either merchandise inventory or prepaid expenses in the form of money is more remote than the realization of accounts receivable by an important step. The realization of merchandise inventory and prepaid expenses is dependent upon the ability to sell at a price sufficient to cover costs.

We think that there are two accounting practices in particular which have contributed to a misunderstanding about the nature of prepaid expenses. The first is the practice of excluding selling, administrative, and financial expenses from "cost of goods sold" so that the figure of cost of goods sold does not include *all* the cost of goods sold. The accountant's specialized method of calculating merchandise cost forces us to reason that something besides merchandise (as defined in terms of its cost) is sold to the customer. If, on the other hand, the accountant were to treat selling, administrative, and financial expenses as part of the cost of goods sold (which, whatever the practical difficulties of doing so, more nearly accords with the facts) prepaid expenses would disappear as a separate item on the balance sheet; prepaid expenses would then properly be included in the cost of merchandise on hand.

The second accounting practice which has bedevilled the understanding of prepaid expenses is the conventional classification of assets as "current" and "fixed". The true nature of prepaid expenses would be much more apparent if instead of classifying assets as either "current" or "fixed", assets were classified as (i) *cash and claims to cash* (accounts receivable and bond investments) and (ii) *unexpired costs* (merchandise inventory, prepaid expenses, and fixed assets).

* * * *

A result of excluding selling, administrative, and financial costs from cost of goods sold is that "cost of goods sold" is commonly regarded as being a prior charge against revenue in the measurement of income. *First,* cost of goods sold is deducted from revenue, *then* the other expenses are deducted. One can almost sense a kind of accounting contempt for the "other" (i.e. lesser) expenses.

At page 67 in *Corporate Accounting Standards* Paton and Littleton protest against this attitude towards costs. They write, "In their essential relation to revenues, as in their essential relation to assets, all costs are homogeneous and rank abreast; this is a basic principle in the development of a reasonable scheme of matching charges and revenues. Costs, in other words, are not recovered through revenues in preferential order. . . . This point deserves emphasis, for there is much unreasonable thinking and loose action, in accounting as well as elsewhere, which grows out of the neglect of this underlying premise. The persistent overstressing of the distinction between merchandise cost of sales and other operating charges in the trading field illustrates the tendency to indulge in questionable ranking. All costs necessary to the product of the business, in trading as well as in other lines, are on a common level of general significance. There can be no income until all costs are covered. . . ."

CORRESPONDENCE

Winnipeg, Man.

Sir: Accepting your invitation to discuss the problems and solutions included in your August 1953 edition, I submit the following criticisms of both Problem 2 and the solution submitted.

Ignoring the unfortunate typographical errors in the solution which showed the property transferred by D as $125,000.00 instead of $175,000.00 and by D's wife as $75,000.00 instead of $25,000.00, I suggest that the person preparing the published solution has not fully considered s. 61(3) of the Income Tax Act wherein it states that "The part of the income of a personal corporation that shall be deemed, under this section, to have been distributed to and received by a shareholder of the corporation, shall be the proportion thereof that the value of all property transferred or loaned to the corporation by the shareholder *or any person by whom his share was previously owned* is of the value of the property so acquired by the corporation from all its shareholders."

The following questions came to my mind on reading the problem:

(a) What was the par value of the shares issued to each of D and his wife in consideration of the property to the value of $200,000.00 acquired from them?

The problem states that on its formation in 1945 the company acquired property to the value of $175,000.00 from D and $25,000.00 from his wife. It does not state that at that time D received 999 common and 900 preferred and D's wife 1 common and 100 preferred shares and one might assume that each received shares to the par value of the property he or she transferred to the company.

(b) Did the wife *sell* any of her shares to her husband?

A careful student might reasonably assume that, as D now holds shares (including those transferred to his son) having a total par value of $189,900.00, and his wife holds shares having a total par value of $10,100.00, there had been a transfer of shares from D's wife to D amounting to $14,900.00 subsequent to the formation of the company. If this transfer was made by way of a sale, the par values of the existing shareholdings rather than of the original shareholdings become significant, in terms of the above quotation from the Act.

(c) Were any balances standing at the debit or credit of the shareholders' personal accounts at the end of 1951?

The problem states that the corporation has assets to the value of $450,000.00 without stating whether or not this is a market value or book value and without mentioning the existence of any liabilities. No indication is given as to the disposition of the income subsequent to the formation of the company other than in respect of the year 1951. One might therefore look for a sur-

plus which would not present any complication, or for shareholders' credit balances representing dividends which had been transferred to the personal accounts of shareholders. In the later case the amount of the credit balances of the individual shareholders should be taken into account in dividing the income for the year. This possibility is scarcely refuted by the statement "no property has since been acquired by transfer or loan from any shareholders."

A further criticism involves the use of the word "profit" in the question instead of the word "income" which has the technical meaning desired here. A "profit" of $35,000.00 could include a profit on the sale of securities which was not regarded as income. As a personal corporation, by definition, cannot carry on an active financial, commercial or industrial business I suggest that the reference to a "profit" of $35,000.00 was inappropriate.

WILLIAM H. GRAY, C.A.

Toronto, Ont.

Sir: The answers given in the September issue as a solution to Problem 1 would deserve, I think, a very low grade.

(a) Par value could be defined more simply as the amount of capital supposed to be brought into the company for each share issued. No question is asked about the relation of book value or market price so there is no occasion to mention them.

(b) Shares are *not* issued for *any* price at which they can be sold. They *cannot* be issued unless (1) the price is par or over or (2) the company is a mining or similar company which is especially authorized to issue shares at a discount. Shares are issued for more than par where the purchaser is willing to pay the premium presumably because of the actual or potential value of the shares warranting the premium.

(d) Anybody can call a class of shares "preferred" and the nature of the preference would have to be ascertained by examination of the terms. Usually preferred shares are entitled to preference to dividends and to repayment on liquidation as compared with the common or some other class of stock. Usually, also, preference shares do not have voting rights or any other measure of control unless their dividends or other rights are in arrears.

(e) It cannot be thought that this question is supposed to bring out an explanation of when capital might best be raised by the respective classes of shares, because the marks are totally inadequate for an explanation of this sort. Therefore, the answer should simply be that the incorporators would estimate what preferred and common shares respectively they intended to issue or might want to issue.

R. B. TAYLOR, F.C.A.

PUZZLE

Tom and Harry were joint heirs to an estate of 1,000 acres. They divided it between them. If Tom's share had been one-third greater in area than was actually the case, Harry's share would have been 20 per cent smaller.

How many acres did they respectively receive?

(Contributed by a Vancouver reader)

SOLUTION TO THE OCTOBER PUZZLE

Let A = 1; B = 2, etc.
Then LANE = 12 + 1 + 14 + 5 = 32
LLOYD = 12 + 12 + 15 + 25 + 4 = 68, etc.
Whence LECKIE = 12 + 5 + 3 + 11 + 9 + 5 = 45.
So my friend's number was 45.

FIFTY YEARS OF GARNER VERSUS MURRAY

(an article contributed by an accountant in Toronto)

May I suggest that it would be appropriate for The Students' Department for November to include some reference to the *Garner* v. *Murray* ruling? That ruling will be 50 years old in November 1953.

Garner, Murray, and Wilkins entered into partnership agreeing to contribute capital in certain unequal shares but to divide profits equally. On a subsequent dissolution of the firm the assets realized sufficient to pay the creditors and advances of two of the partners, but were insufficient to repay the partners' capitals. The position was approximately as follows:

BALANCE SHEET AT 30 JUNE 1900

Liabilities

Capital accounts	
Garner	£2,500
Murray	314
	£2,814

Assets and Deficit

Cash	£1,916
Wilkins (overdrawn)	263
Deficiency of firm	635
	£2,814

Wilkins was unable to contribute anything and a dispute arose between Garner and Murray as to how the available assets should be distributed between them. Mr. Justice Joyce held (i) that a loss arising through the default of one of the partners must be distinguished from an ordinary trading loss or loss on realization; (ii) that, provided outside creditors' claims had been met, the liability of each separate partner was limited to making good his share of the deficiency; (iii) that, in the case in question, each partner should be treated as liable to contribute an equal third share of the deficiency; and (iv) that the assets should then be applied in paying each partner ratably what was due to him in respect of capital.

When studying the *Garner* v. *Murray* decision a few years ago I was most anxious to see the actual ruling in the hope that the reasoning expressed in it might lead to a better understanding. I never did so, but it has always been in the back of my mind to do so, and lately after much searching I found two books in the Public Reference Library which yielded interesting results.

"Advanced Accounting" by L. R. Dicksee, 1905 edition, contained the following summary of the "recent" ruling in the Appendix, being part of the "Law Relating to Accounts" by J. E. G. de Montmorency:

"In that case [*Garner* v. *Murray*] the plaintiff entered into partnership with the defendant Murray and Wilkins under a parol agreement that the capital of the business should be contributed in certain unequal shares and that each partner should be entitled to one third net share of the profits. The partnership was dissolved by order of the Court as from 30th June 1900. After payment of all debts due from the firm it was found that the assets would be insufficient to repay the capital by the sum of £897 - 3 - 8d. The deficit was due to the default of Wilkins who failed to contribute his share of the deficiency of the assets to make good the capital. Each partner ought to have contributed one-third of the sum of £897 - 3 - 8 and then the capital should have been distributed rateably among the partners. But as Wilkins could contribute nothing, how was the ultimate deficiency to be borne by Garner and Murray? It was argued that each partner ought to bear an equal loss, but Joyce, J. rejected this contention. 'When the Act says losses are to be borne equally it means losses sustained by each person to be of equal amount. There is no rule that the ultimate personal loss of each partner after he has performed his obligation to the firm shall be the same as or in any given proportion to that of any other partner. I have to follow the Act and I see no difficulty in doing so in this case. The assets must be applied in paying to each partner rateably what is due from the firm in respect of capital, account being taken of the equal contributions to be made by him towards the deficiency of capital. . . . The true principle of the division of assets is therefore for each partner to be treated as liable to contribute such a share of capital deficiency as he would take in profits (in

this case one third) and then for the assets to be paid to each partner rateably in respect of capital."

"Advanced Accounts" by F. N. Carter, 1943 edition, contained the following discussion and summary of the arguments for and against this ruling:

"Whenever a partner is unable to repay to the firm his indebtedness, the ruling of *Garner* v. *Murray* must be applied. This decision by Mr. Justice Joyce, in November 1903, was that the solvent partners are only liable to make good their share of the deficiency, and that the remaining assets should be divided among them in proportion to their capitals. In other words, the loss caused by the default of an insolvent partner is to be borne in proportion to capital and not in the proportion that ordinary losses are to be borne.

"The decision caused great surprise in accountancy circles, which had not previously discriminated between an internal and an external loss, i.e., between a loss occasioned by the default of a partner, and an ordinary trading loss. As previously explained, under the old method the £263 would have been added to the £635, and the total loss of £898 would have been borne by the solvent partners in the same relative proportions in which they had previously shared profits, namely 1:1 or one-half each. The effect of Mr. Justice Joyce's decision, however, was that the £635 should be shared by all the partners in the same way that they shared ordinary profits and losses, i.e., one-third each; but that Wilkins' £263 and share of deficiency should be borne by the solvent partners in the proportion of their capitals. For although the solvent partners are not liable to "make good" the insolvent partner's overdraft and share of the deficiency, yet inasmuch as his default causes a deficiency of assets, it follows that the solvent partners actually bear this loss of cash in the same proportion in which they share the actual cash, namely, in proportion to their capital, i.e., in the ratio which each partner's capital bears to the total capital of the partners. . . .

"The decision occasioned much comment and discussion which finally developed into a sharp controversy, raging chiefly round the precise meaning of the judge's words, 'making good his share of the deficiency'. Many accountants contended it meant that the solvent partners should bring in cash; others contended this was unnecessary, so long as there was a sufficient credit balance in his Capital account to liquidate his share of the firm's deficiency. The arguments and counter-arguments are as follows:

1. The solvent partners should bring in cash, which should be debited to Cash account and credited to the Deficiency account, thus actually carrying out the letter of the law, and 'making good' their shares of the deficiency. The arguments against this course are:

(1) that it is unreasonable to ask a partner to bring in cash when he already has a credit balance in his capital account;

(2) that it might be impossible, as the partner might have sunk the whole of his capital in the business; and

(3) that it is quite contrary to accountancy practice in other cases, where, if the result of a realization is to place a partner's account in debit, such deficit is often made good by transfer from his current account, and even from his loan account if he has one.

In reply, it is urged that these objections are not points of equity but merely sentimental reasons and questions of convenience, which do not invalidate the argument that this method fulfils the letter of the law.

2. The solvent partners should have their shares of the deficiency debited to their capital accounts. In opposition to this course it is contended:

(1) that debiting a loss to capital is not making it good;

(2) that the capital accounts as per the last balance sheet represent the partners' agreed shares of such capital, and are, according to the judgment, to form the basis for distribution of the assets;

(3) that to debit the shares of deficiency to the capital accounts would alter the capital accounts and destroy the basis for the distribution of the assets; and

(4) that this flaw in fulfilling the condition of the judgment vitiates this method.

3. The solvent partners should be shown on the balance sheet as debtors for their shares of the deficiency. This would prevent the capital accounts being altered. The objections raised to this course are:

(1) that it is an attempt to carry out the judgment by means of a paper entry instead of an actual contribution; and

(2) that in the case of fixed capitals a partner who had a credit balance in his current account could offset it against this debit, and thus render this method futile."

Editor's Note on the Garner v. Murray Decision

The decision as it is outlined in the above article would appear to require the following distribution between Garner and Murray:

	Garner	Murray	Wilkins	Total
Capitals before charging "deficiency" (i.e., loss on realization)	2,500	314	(263)	2,551
Deficiency of firm, charged in profit ratio	212	212	211	635
Capitals, adjusted for loss on realization	2,288	102	(474)	1,916
Add capital introduced to meet deficiency	212	212	—	424
	2,500	314	(474)	2,340
Available cash distributed ratably in respect of capital, i.e., in ratio 2,500:314	2,079	261	—	2,340
Loss caused by default of Wilkins borne by solvent partners ratably in respect of capital, i.e., in ratio 2,500:314	421	53	(474)	—

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner, but rather to provide such discussion and explanation of the problems as will make their study beneficial. The editor will welcome discussion of the solutions published.

PROBLEM 1

Intermediate Examination, October 1952

Accounting II, Question 4 (15 marks)

CA has found that the bookkeeper of X Co. Ltd., has calculated the net profit for the year ended 31 Dec 1951 at $86,510.20 and his enquiries have disclosed the following:

(i) Accrued and deferred items as at 31 Dec 1951 not taken into account:

(a) Deferred rental income	$1,500
(b) Insurance unexpired	1,200
(c) Direct labour accrued	5,450
(d) Interest expense prepaid	867
(e) Interest income unearned	950
(f) Interest income accrued	1,350

(ii) (a) Instructions that an additional $6,000 be provided for doubtful accounts at the year end had been ignored.

(b) Accounts receivable of $1,000 had been reported as uncollectible earlier in the year but had not been deleted from the accounts. This item relates to 1950 sales.

(iii) A final instalment of $4,476 on the refundable portion of excess profits taxes had been included in sundry revenue.

(iv) On 31 Dec 1951 customers returned goods invoiced at $6,508. These were included in the year end inventory but the entry in the accounts was not made until the first day of the new fiscal period.

(v) The closing inventory did not include $5,000 of merchandise received on 30 Dec 1951, for which the liability had been set up.

(vi) Included in accounts receivable and sales was $2,530, representing consignment shipments to a company agent at 125% of cost, all of which was reported by the agent to be on hand at the year end date.

(vii) Dividends declared on the 30th November 1951, payable 15th January 1952, in the amount of $30,000 had not been recorded in the accounts.

(viii) Depreciation was to have been provided at 10% on the balance in the machinery and equipment account, which was $142,700 as at 31st December 1951. The bookkeeper charged depreciation at 10% on this balance after deducting the accumulated depreciation account of $58,520. During the year ordinary repairs to machinery costing $5,500 had been charged to the machinery and equipment account.

(ix) Office salaries amounting to $575 had been charged to salesmen's salaries.

(x) No entry had been made in respect of the December salesmen's commissions. The cheques issued on 5 Jan 1952 in this respect totalled $4,167 being the amounts payable after deducting income taxes totalling $613.

Required:

Statement showing for each of the above items the amount by which the net profit, as reported by the bookkeeper, should be increased or decreased and the adjusted net profit.

A SOLUTION

X CO. LTD.

STATEMENT OF ADJUSTED NET PROFIT

for the year ended 31 Dec 1951

	Decrease	Increase	
Net profit, per bookkeeper			$86,510.20
(i)			
(a)	$ 1,500		
(d)		$ 867	
(b)		1,200	
(c)	5,450		
(e)	950		
(f)		1,350	
(ii)			
(a)	6,000	nil	
(b)	nil		
(iii)	4,476		
(iv)	6,508		
(v)		5,000	
(vi)	506		
(vii)	nil	nil	

(viii)	5,302)		
	5,500)		
(ix)	nil	nil	
(ix)	4,780		
	$40,972	$8,417	
			8,417.00
			94,927.20
			40,972.00
Adjusted net profit			$53,955.20

Editors Note: In the editor's opinion, one might argue that "interest income unearned" [see part (i) of the above problem] should *not* be taken into account and that, accordingly, no revision of reported profit is required in respect of this item. The solution appearing above interprets the item to mean "interest income received but unearned".

PROBLEM 2

Intermediate Examination, October 1952

Accounting II, Question 5 (25 marks)

A & B PARTNERSHIP

BALANCE SHEET

as at 30 Sept 1952

Cash	$ 2,640	Accounts payable	$19,462
Accounts receivable	24,621	Accrued liabilities	6,121
Merchandise inventory	31,467	Mortgage loan	60,000
Land	13,165	Current account A	1,373
Buildings	37,864	Capital account A	50,000
Machinery	61,349	Current account B	1,920
Unexpired insurance	1,248	Capital account B	25,000
Goodwill	10,000	Accumulated depreciation	18,478
	$182,354		$182,354

A and B share profits in the ratio of 2:1

C & D PARTNERSHIP

BALANCE SHEET

as at 30 Sept 1952

Cash	$14,181	Accounts payable	$61,484
Accounts receivable	37,464	Accrued liabilities	4,236
Merchandise inventory	41,298	Capital account C	15,000
Machinery	20,549	Capital account D	37,500
Organization expense	5,740	Current account C	4,081
Goodwill	5,000	Accumulated depreciation	6,049
Prepaid rent	2,500		
Current account D	1,618		
	$128,350		$128,350

C and D share profits in the ratio of 2:3

The partners of the above firms are considering combining their businesses and forming a company to be known as the ABCD Co. Ltd.

The following matters relating to each of the partnerships were reported:

(a) AB partnership

(i) Accounts receivable include overdue accounts of $4,300 due from customers in process of liquidation which will realize 10c on the dollar.

(ii) Inventory includes certain items of a current and useful nature aggregating $13,500, which had been marked down by 25% of cost.

(b) CD partnership

(i) Deliveries of goods on 27 to 30 Sept 1952 amounted to $10,500 at selling price. These goods were not billed until October and were not included in the closing inventory.

(ii) Accounts receivable include overdue accounts of $8,500 due from customers in process of liquidation which will realize 25c on the dollar.

It was agreed that:

(i) the overdue accounts receivable in liquidation should be adjusted to estimated realizable values,

(ii) for the purposes of the reorganization goodwill is to be revalued at $40,000 for the AB partnership and at $30,000 for the CD partnership,

(iii) the books of the AB partnership should be adjusted to revalue the portion of the inventory referred to in (a) (ii) at cost and of the CD partnership to adjust the error reported in (b) (i) above,

(iv) the two businesses should be combined as from 1st October 1952 as the ABCD Co. Ltd., and capitalized at 5,000 preferred shares with a par value of $25 each and 500,000 common shares of a par value of $1 per share. The preferred shares to be allotted as required to each firm in proportion to their contribution of fixed assets, with common stock for the balance,

(v) for the purpose of computing the preferred stock allotment, the mortgage loan is to be deducted from the fixed assets of the AB partnership, and the preferred shares are to be allotted as between partners in the profit and loss sharing ratio,

(vi) the necessary common shares are to be issued at par to the partners to settle the balances of their individual partners accounts.

Required:

(a) Statement showing your computation of the preferred and common shares in ABCD Ltd. allotted to each of the partners.

(b) Balance sheet of ABCD Ltd. as at 1st Oct 1952 after giving effect to the above.

A SOLUTION

(a)

ABCD LTD.

COMPUTATION OF PREFERRED AND COMMON SHARES ALLOTTED, 1 OCT 1952

Assets taken over for preferred shares

		AB		CD	
Land		$13,165			
Buildings	$37,864				
Machinery	61,349			$20,549	
	99,213				
Less reserve for depreciation	18,478	80,735		6,049	
		93,900			
Less mortgage loan		60,000			
			$33,900		$14,500

Allotment of preferred shares

AB

No. of shares issued $\frac{\$33{,}900}{\$25}$ = 1,356 shares

To A 2/3 of 1,356 = 904 @ $25	$22,600
B 1/3 of 1,356 = 452 @ $25	11,300
	$33,900

CD

No. of shares issued $\frac{\$14{,}500}{\$25}$ = 580 shares.

To C 2/5 of 580 = 232 @ $25	5,800
D 3/5 of 580 = 348 @ $25	8,700
	$14,500
	$48,400

Net assets taken over for common shares

	A & B	C & D	Total
Cash	$ 2,640	$14,181	$16,821
Accounts receivable less allowance	20,751	41,589	62,340
Inventory	35,967	41,298	77,265
Prepaid rent		2,500	2,500
Unexpired insurance	1,248		1,248
Goodwill	40,000	30,000	70,000
	$100,606	$129,568	$230,174
Less accounts payable	$19,462	$61,484	$80,946
Accrued liabilities	6,121	4,236	10,357
	$25,583	$65,720	$91,303
			$138,871

Allotment of common shares

AB

	A	B	Total
Capital accounts 30 Sep 1952	$50,000	$25,000	$75,000
Current accounts 30 Sep 1952	1,373	1,920	3,293
Revaluation of goodwill	20,000	10,000	30,000
Revaluation of inventory	3,000	1,500	4,500
	74,373	38,420	112,793
Less write-down of accounts receivable to realizable values	2,580	1,290	3,870
Revised equity of partners	71,793	37,130	108,923
Preferred shares allotted	22,600	11,300	33,900
Common shares allotted	$49,193	$25,830	$75,023

CD

	C	D	Total
Capital accounts 30 Sep 1952	$15,000	$37,500	$52,500
Current accounts 30 Sep 1952	4,081	(1,618)	2,463
Revaluation of goodwill	10,000	15,000	25,000
Understatement of profit for the year ended 30 Sep 1952	4,200	6,300	10,500
	33,281	57,182	90,463
Deduct			
Write-down of accounts receivable to realizable values	2,550	3,825	6,375
Write-off of organization expense	2,296	3,444	5,740
	4,846	7,269	12,115
Revised equity of partners	28,435	49,913	78,348
Preferred shares allotted	5,800	8,700	14,500
Common shares allotted	$22,635	$41,213	$63,848

ABCD CO. LTD.

BALANCE SHEET

as at 1st October 1952

ASSETS

Current		
Cash on hand and in bank	$ 16,821	
Accounts receivable	62,340	
Merchandise inventory at cost	77,265	
Prepaid rent	2,500	
Unexpired insurance	1,248	$160,174

Fixed				
Land		13,165		
Buildings	$ 37,864			
Machinery	81,898			
	119,762			
Less depreciation accumulated	24,527	95,235	108,400	
Goodwill at value agreed upon			70,000	$338,574

LIABILITIES

Current			
Accounts payable	$ 80,946		
Accrued liabilities	10,357	$ 91,303	
Mortgage on real estate (due)		60,000	
Capital			
Authorized: 5,000 preferred $25 par value			
500,000 common $1 par value			
Issued: 1,936 preferred shares for assets taken over	48,400		
138,871 common shares for assets taken over	138,871	187,271	$338,574

PROBLEM 3

Final Examination, October 1952

Accounting III, Question 1 (15 marks)

It has been suggested that financial statements should be adjusted to take into account the effects of the changing value of the monetary unit, the dollar. In particular, criticism has been directed to the figures presently shown for depreciation and inventories.

Required:

Discuss briefly the arguments for and against such proposals taking into consideration the effect of their adoption on the usefulness of comparative statements.

A SOLUTION

Arguments in favour of adjusting financial statements to give effect to the changing value of the dollar

1. The adjustment tends to match current costs with current revenues by reflecting profit and loss charges based on replacement costs.
2. Depreciation based on replacement cost will provide additional funds for the replacement of equipment in times of rising prices.
3. The adjustment will make the financial statements more comparable over a period of years because income is related to a constant factor (purchasing power).
4. The financial statements of different concerns should be more comparable because the same replacement costs are reflected in the measurement of income. The actual costs of the different concerns, on the other hand, may vary considerably.

Arguments against adjusting financial statements to give effect to the changing value of the dollar

1. Direct manufacturing costs do reflect the changing value of the dollar. This is true of labour costs and it is also true of material costs except for the variation resulting

from the method of inventory valuation. Further, a frequent turnover of inventories during the year minimizes the variation resulting from inventory valuation.

2. Recording depreciation on a replacement cost basis may provide necessary funds to give effect to that year's inflationary increase in costs, but this procedure does not correct for previous years and thus may not, in the long run, fully achieve its purpose. Further, the replacement cost basis of depreciation requires two assumptions which are unreal, viz.,
   (i) that similar equipment will be required to replace existing equipment. Actually, technological advances, improvements in design, mass production and alternative methods may result in the re-equipping of the plant at a lower cost even in times of inflation; and
   (ii) that providing funds for the replacement of assets is the prime purpose of depreciation. This is not the accepted or correct concept. The purpose of recording depreciation is to spread the net cost of an asset over its useful life in an equitable manner. The provision of funds for the replacement of assets at inflated figures should be a consideration of the management and may be reflected in the figure of income if desired but if so, the provision, which is at best an arbitrary calculation, should be reflected as a separate item, suitably described, and should not be buried under the heading of depreciation.
3. To record depreciation on a replacement cost basis, the assets would have to be revalued annually or the relationship between the asset values and the accumulated depreciation would be meaningless. Such revaluations would be, at best, arbitrary, and would permit the whims of management to distort the financial statements.
4. Each financial statement would have to have a prologue outlining the basis adopted in its preparation to permit intelligent interpretation.
5. Comparative statements would likely result in a distorted picture with the inclusion of arbitrary fixed asset costs unless these adjustments were definitely segregated.

EXAMINER'S COMMENTS

Some candidates showed a lack of ability to segregate their points clearly.